# Indiana Law Review



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# ARTICLES

## SUPPORTING THE SUPPORTING ORGANIZATION: THE POTENTIAL AND EXPLOITATION OF 509(A)(3) CHARITIES

ALYSSA A. DIRUSSO*

*"One of the serious obstacles to the improvement of our race is indiscriminate charity."*

Andrew Carnegie[1]

SUMMARY

Supporting organizations, a type of charity defined in section 509(a)(3) of the Internal Revenue Code, have vast potential for philanthropic impact but perhaps equally vast potential for abuse. Donors who establish supporting organizations may retain inappropriate levels of control over the assets they contribute, hoard funds within the organization rather than actually using them to accomplish a charitable benefit, or engage in abusive financial transactions with their supporting organization. This Article discusses the complex tax rules that apply to supporting organizations and explains their unique role in charitable giving. It then explores the allegations of abuse in the supporting organization realm and reviews current proposals for reforming the system. The Article concludes by recommending that the public disclosure rules be amended to require fuller transparency of the activities of supporting organizations and greater availability of this information.

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* Assistant Professor of Law, Samford University, Cumberland School of Law; J.D., University of Texas School of Law; B.S., Carnegie Mellon University. The author wishes to thank the Cumberland School of Law for a summer research grant that supported work on this Article, participants in the faculty seminar at Cumberland, faculty who attended the presentation of this Article at Florida State University, and the following individuals for their comments and assistance: research assistant Andrea Weed, Brannon Denning, Joshua Tate, Joseph Dodge, Kathleen M. Sablone, Jim Exum, Jedidiah McKeehan, and Ayanna Sterling-Jones.

1. *See* The Quotations Page, Quotations by Author, Andrew Carnegie, http://www.quotationspage.com/quotes/Andrew_Carnegie/ (last visited Feb. 7, 2006).

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## INTRODUCTION

Charity is perhaps the most regulated of the seven virtues. Although charity is often motivated by the best of intentions, modern charitable giving is riddled with scandals, complex regulations, and the overarching need for reform. One area of charitable giving struggling for legitimacy is the supporting organization,[2] a type of charity that derives its freedom from income tax by reason of its relationship with other charities who enjoy broad public support.[3]

Supporting organizations are growing in popularity, net worth, and importance.[4] According to the National Center for Charitable Statistics, there was a 26.1% increase in the number of existing supporting organizations between 1996 and 2004.[5] In 2001, there were almost 400 large supporting organizations (organizations with assets over $50 million) with total assets of $76.7 billion.[6] In 2004, a total of 45,453 supporting organizations were associated with public charities.[7]

While many wealthy Americans are doing well by doing good, a clever and devious few are using the complicated supporting organization structure for doing well by doing bad. The regulations that apply to supporting organizations are detailed and complex, but loopholes exist and the system is, to some degree, being exploited. Unlike private foundations,[8] supporting organizations have no regime of excise taxes restricting their behavior, and these organizations can be manipulated through self-dealing transactions that are hard to detect.[9]

A tight legal framework is necessary to prevent supporting organizations

---

2. *See* I.R.C. § 509(a)(3) (2000). A "supporting organization" maintains certain relationships with other charities. *Id.* Examples of a supporting organization include a university printing press, Friends of the Swampscott Public Library, Friends of Harvard College, or similarly named groups.

3. *See id.* § 509(a)(1)-(2). A "publicly supported organization" is a type of charity that generally is required to obtain a substantial amount of its support from the general public or from gross receipts from its charitable activities. *Id.* Examples of publicly supported organizations include museums, orchestras, universities, and churches.

4. Recent testimony before the Senate Finance Committee given by Jane G. Gravelle, Senior Specialist in Economic Policy for the Congressional Research Service of the Library of Congress, examined the issues surrounding supporting organizations. *See Charities and Charitable Giving: Proposals for Reform: Hearing Before the S. Comm. on Finance*, 109th Cong. (2005) (statement of Jane G. Gravelle, Senior Specialist in Economic Policy Congressional Research Service), *available at* http://www.finance.senate.gov/hearings/testimony/2005test/jgtest040505.pdf [hereinafter Gravelle Statement].

5. *See id.; see also* National Center for Charitable Statistics, Number of Nonprofit Organizations in the United States 1966-2004 (Dec. 2004), *available at* http://nccsdataweb.urban.org/PubApps/profile1.php?state=US.

6. *See* Gravelle Statement, *supra* note 4, at 13.

7. *See id.*

8. *See* I.R.C. §§ 4941- 4945 (2000).

9. *See* Gravelle Statement, *supra* note 4, at 14.

from being abused. The regulations governing supporting organizations are already extremely complex. It is not exactly a compliment for a tax regulation to be called "fantastically intricate and detailed" by a federal district court judge, as supporting organizations have been.[10] But are the supporting organization regulations themselves the problem, and are they the only source of a solution?

Some reformers believe rewriting the supporting organization regulations is necessary—perhaps even to the extent of eliminating a form of supporting organization that the regulations created. Would this approach be necessary or sufficient? Or might the problems with supporting organizations lie not in their structure, but in their oversight? This Article suggests the latter. The abuses plaguing the supporting organization culture may be related to the way in which supporting organizations are required to share their information with the public: the public disclosure rules.

Supporting organizations offer a creative planned giving option and a unique charitable structure. This Article explores the role of these charities, the abuses related to them, and proposals for reforming them. First, Parts I and II discuss the history of supporting organizations and the tax rules that govern them. Next, Part III explores what makes supporting organizations such a unique and useful charitable tool. Part IV then examines modern concerns with supporting organization abuse, and Part V discusses proposals for reform. Finally, Part VI recommends a way to reform supporting organizations through a back-door—by expanding the public disclosure requirements.

## I. HISTORY OF SUPPORTING ORGANIZATIONS

Supporting organizations, in their current form, were established by the Tax Reform Act of 1969 ("Tax Reform Act").[11] This legislation, aimed at curbing abuse of tax-exempt charitable foundations, distinguished two categories of exempt organizations: those that were categorized as private foundations and those that were not.[12] Among those exempt organizations not categorized as private foundations were publicly supported charities,[13] gross receipts charities,[14] organizations promoting public safety,[15] and supporting organizations.[16] The legislative history relating to supporting organizations in the Tax Reform Act is

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10. Windsor Found. v. United States, No. 76-0441-R, 1977 U.S. Dist. LEXIS 13643, at *5 (E.D. Va. Oct. 4, 1977). District Judge Warriner explained that "the Internal Revenue Service has drafted fantastically intricate and detailed regulations in an attempt to thwart the fantastically intricate and detailed efforts of taxpayers to obtain private benefits from foundations while avoiding the imposition of taxes." *Id.*

11. Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487 (codified as amended at I.R.C. § 509 (2000)).

12. *See* I.R.C. § 509(a)(1) (2000).

13. *See id.* § 509(a)(2)(A)(i).

14. *See id.* § 509(a)(2)(A)(ii).

15. *See id.* § 509(a)(4).

16. *See id.* § 509(a)(3).

relatively sparse. The Senate Report (No. 91-552)[17] and House Report (No. 91-413)[18] mention supporting organizations only briefly. Notwithstanding the brevity of the congressional record, a review of the legislative history demonstrates a consistency in the justification for tax-exempt status of supporting organizations.

The oversight rules created in the Tax Reform Act, applicable to private foundations, were created to combat abusive transactions rampant in the world of charitable foundations. Public charities were not subject to these rules, based on the belief that dependence on public support and accompanying public scrutiny would prevent such abuse from occurring with charitable funds.[19] Supporting organizations were distinguished from organizations subject to the rules applicable to private foundations because, in theory, "[supporting organizations] are subject to the scrutiny of a public charity."[20]

### *A. House and Senate Reports of the 1969 Tax Reform Act*

The House Report of 1969 explains the establishment of section 509, defines "private foundations," and explores why certain types of charities are excluded from this definition and the rules incumbent upon private foundations.[21] After differentiating publicly supported organizations and gross receipts organizations, the House discussed supporting organizations:

> Another category of organizations removed from the definition of private foundations comprises those organizations which are organized and operated exclusively for the benefit of one or more of the 30-percent organizations or broadly based organizations described above, provided that they are operated, supervised, or controlled by one or more such organizations, or in connection with one such organization, and are not controlled directly or indirectly by disqualified persons (other than foundation managers, 30-percent organizations, and broadly based organizations described above). In general, religious organizations other than churches, the Hershey Trust (which is organized and operated for a specific school for orphaned boys and is controlled in connection with that school), university presses, and similar organizations are examples of organizations expected to qualify for this category.[22]

The Senate Report is virtually identical but does not name the Hershey Trust explicitly. Instead, it generally describes "organizations organized and operated for the benefit of a specific school and also controlled by or operated in

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17. *See infra* note 23.
18. *See infra* notes 21-22.
19. Quarrie Charitable Fund v. Comm'r, 603 F.2d 1274, 1277-78 (7th Cir. 1979).
20. *Id.* at 1278.
21. H.R. REP. NO. 91-413, pt. 1 (1969), *as reprinted in* 1969 U.S.C.C.A.N. 1645, 1686.
22. *Id.* at 225-27.

connection with that school."[23]

Although the legislative history is sparse, the reasoning behind Congress's creation of supporting organizations is expressed consistently. Supporting organizations do not need the rigorous oversight of the private foundation tax rules because they are theoretically monitored by publicly supported charities and therefore are indirectly overseen by the public. The same justification for their tax exemption has been expressed in case law.

In *Cockerline Memorial Fund v. Commissioner*,[24] the Tax Court discussed Congress's intent when it enacted section 509.[25]

> Public charities are exempt from private foundation treatment and, consequently, the excise taxes, on the theory that public scrutiny arising from a foundation's dependence upon public funds will prevent abusive acts by the foundation. Supporting organizations are similarly excepted on the theory that scrutiny by the publicly supported organizations will prevent abuse by the supporting organization. The belief that scrutiny by a publicly supported organization, under the appropriate circumstances, is sufficient to guard against abuse by the supporting organization is embodied in section 509(a)(3). The provisions of that section are designed to insure that a supported organization has the ability and motivation to properly oversee the activities of the supporting organization.[26]

In *Cockerline*, the court concluded that a "close and continuous relationship" existed between the supported charity and the petitioner involved in the case.[27] The relationship produced "the type of close scrutiny which renders unlikely the congressionally feared abuses," and, in fact, no such abuses occurred in the *Cockerline* organization.[28]

It is clear that Congress acknowledged the special role supporting organizations play and intended to provide a structured context in which supporting organizations would operate scrupulously. This structure relies upon attention by the supported charity to insure that abuses are curtailed.

### *B. Like Taxes for Chocolate—The Hershey Trust Testimony*

The Hershey Trust and its proponents were critical in developing the treatment of the supporting organization as exempt from the private foundation taxes of the 1969 Tax Reform Act. Pennsylvania's senior senator, Hugh D. Scott, Jr., offered several pages of testimony explaining why the enactment of section

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23. S. REP. NO. 91-552 at 460-62 (1969), *as reprinted in* 1969 U.S.C.C.A.N. 2027, 2085-86.
24. 86 T.C. 53 (1986).
25. *Id.* at 64-65.
26. *Id.* at 65 (internal citations omitted).
27. *Id.*
28. *Id.*

509(a)(3) was of particular importance to the Hershey Trust.[29]

The Milton Hershey School is an institution that originally housed poor orphan boys in Hershey, Pennsylvania.[30] Milton Hershey, who founded the Hershey Chocolate Company, established the school in 1909, before federal income taxes. Rather than funding the school directly, he established two entities: the school itself and a trust to hold the school's assets. The school qualified as a publicly supported charity because it was an educational organization, having a regular faculty, curriculum, and student body. The IRS apparently considered the trust to be effectively the same entity as the school, since the governing body of the trust and the school were the same and had similar purposes.[31]

However, the 1969 Tax Reform Act caused some concern that the trust would be treated as a private foundation under the new rules. Senator Scott defended the trust, stating that it would be "most unfortunate" if the private foundation rules applied to the trust, and explaining that the "hardship would have been suffered by the School and its students."[32] Senator Scott's pleas on behalf of the Hershey Trust were well received.[33]

References to the Hershey Trust by name appear in the regulations, and it is clear that this organization was critical in securing the advantages of public charity status to supporting organizations. Were it not for the quirky structure of this chocolate charity, supporting organizations might not exist today.

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29. GERALD B. TREACY, JR., SUPPORTING ORGANIZATIONS, at B-401 to -402 (BNA Tax Management Portfolio No. 871-2d, 2002) (excerpting from Congressional Record of December 6, 1969 (page S15982) (Senate Debate)). The Hershey Trust and the administration of its assets have been under public scrutiny in recent years. *See* Evelyn Brody, *Whose Public? Parochialism and Paternalism in State Charity Law Enforcement*, 79 IND. L.J. 937, 985-99 (2004); Mark Sidel, *The Struggle for Hershey: Community Accountability and the Law in Modern American Philanthropy*, 65 U. PITT. L. REV. 1, 2 (2003).

30. The school was originally founded for orphan boys, but the Milton Hershey School now accepts students of both sexes, and they do not have to be orphans. *See* Milton Hershey School, Admissions Criteria for New Students, http://www.mhs-pa.org/admissions/criteria/ (last visited Feb. 7, 2006).

31. *See* TREACY, *supra* note 29, at B-401 (referencing a 1951 Revenue Ruling issued to the school and the trust).

32. *Id.*

33. *Id.* Senator Wallace F. Bennett of Utah, a member of the Committee on Finance, stated in his testimony that he would like to

> assure the senior Senator from Pennsylvania that the committee . . . was very mindful of the problem that certain organizations would have had in the absence of proposed section 509(a)(3) . . . [and that] the sort of situation involving the Milton Hershey School described by the senior Senator from Pennsylvania is what the Committee on Finance had in mind when it approved this part of the bill.

*Id.*

## II. TAX RULES APPLICABLE TO SUPPORTING ORGANIZATIONS

### *A. Overview*[34]

The Tax Reform Act of 1969 created a scheme of rules that apply to private foundations.[35] These regulations specifically did not apply to charities that were not categorized as private foundations.[36] Supporting organizations were not private foundations, and thus were exempt from the new rules.[37]

Supporting organizations are instead subject to the requirements of section 509(a)(3) of the Internal Revenue Code and that section's treasury regulations. Section 509(a)(3) provides that an organization is *not* a private foundation and is therefore classified as a supporting organization if it:

> (A) is organized, and at all times thereafter is operated, exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more specified organizations described in paragraph (1) or (2),
>
> (B) is operated, supervised, or controlled by or in connection with one or more organizations described in paragraph (1) or (2), and
>
> (C) is not controlled directly or indirectly by one or more disqualified persons . . . other than foundation managers and other than one or more organizations described in paragraph (1) or (2).[38]

As developed more fully in the regulations, 509(a)(3) establishes an Organizational Test and an Operational Test (in part A), a Type of Relationship Test (in part B), and a Control Test (in part C).[39] The Organizational and Operational Tests vary depending upon how the organization is classified under the Type of Relationship Test. The best way to understand the regulations is to begin with a discussion of the three types of relationships supporting organizations have with their supported charities.

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34. See Appendix A for a "map" of supporting organization structures resulting from the applicable tax regulations.

35. *See* Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487 (codified as amended at I.R.C. § 509 (2000)).

36. Quarrie Charitable Fund v. Comm'r, 603 F.2d 1274, 1277 (7th Cir. 1979). "The definition of a private foundation is intentionally inclusive: all organizations exempted from tax by Section 501(c)(3) are private foundations except for those specified in Section 509(a)(1) through (4). The exceptions are churches, schools, and hospitals, § 509(a)(1), other publicly supported organizations, § 509(a)(2), and supporting organizations of such excepted organizations." *Id.* (citations omitted).

37. *Id.*

38. I.R.C. § 509(a)(3) (2000). For simplicity, this Article uses the term "charity' to refer to "organizations described in paragraph (1) or (2)."

39. For a good practitioner-oriented overview of the supporting organization rules, see GERALD B. TREACY, JR., SUPPORTING ORGANIZATIONS (1996), and the more recent B.N.A. Tax Management Portfolio of the same title.

### *B. The Type of Relationship Test*

Section 509(a)(3)(B) contemplates three types of relationships between charities and their supporting organizations.[40] The relationships are categorized as Type I, Type II, and Type III, and each type bases its justification for exemption on slightly different language in the Code section.[41] Type I organizations must be "operated, supervised, or controlled by" a charity.[42] Type II organizations must be "supervised or controlled in connection with" a charity.[43] Type III organizations must be "operated in connection with" a charity.[44] Once a supporting organization has established that it meets the description of one of these three types of relationships, it must meet the requirements that apply to that relationship type.

*1. Type I Organizations.*—Type I relationships are perhaps the simplest. A Type I organization must be operated, supervised, or controlled by its supporting charity.[45] Type I relationships are "comparable to that of a parent and subsidiary, where the subsidiary is under the direction of, and accountable or responsible to, the parent organization."[46] Type I relationships are established when the supported charity (through its officers, members, or all or part of its governing body) appoints or elects a majority of the officers, directors, or trustees of the supporting organization.[47] The regulations provide that "the distinguishing feature [of Type I organizations] is the presence of a substantial degree of direction by the publicly supported organizations over the conduct of the supporting organization."[48]

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40. I.R.C. § 509(a)(3)(B) (2000).

41. First, there is a distinction between charities that rely on the word "by" rather than the phrase "in connection with." Charities that rely on the word "by" are classified as Type I Organizations (operated, supervised, or controlled by a charity—"by" relationships). Type I organizations are "*operated, supervised, or controlled by* or *in connection* with" qualifying charities. Second, there is a distinction, among charities that rely on the phrase "in connection with," between charities that rely on the phrase "supervised or controlled," and charities that rely on the word "operated." Charities that rely on the phrase "supervised or controlled" are classified as Type II Organizations (supervised or controlled in connection with a charity—"overseen with" relationships). Type II organizations are "operated, *supervised, or controlled* by or *in connection with*" qualifying charities. Charities that rely on the word "operated" are classified as Type III Organizations (operated in connection with a charity—"operated with" relationships). Type III organizations are "*operated*, supervised, or controlled by or *in connection with*" qualifying charities. *See id.* § 509(a)(3)(B) (emphasis added).

42. *See* 26 C.F.R. § 1.509(a)-4(a)(3) (2005).

43. *Id.*

44. *Id.*

45. *Id.*

46. *See id.* § 1.509(a)-4(g)(1)(i).

47. *Id.*

48. *Id.* § 1.509(a)-4(f)(4). This direction should extend "over the policies, programs, and activities of the supporting organization." *See id.* § 1.509(a)-4(g)(1)(i).

A Type I relationship may exist even though the supporting organization is not governed by representatives of the charity it supports.[49] It is possible for a supporting organization to be "*operated, supervised, or controlled by*" one charity but to be operated "*for the benefit of*" a different charity.[50] These alternative relationship structures for Type I supporting organization are only allowed if it is clear that the purposes of the operating, controlling, or supervising charity are carried out by benefiting the other charity.[51] Although slight variations on the parent-subsidiary relationship are permitted, most Type I supporting organizations are clearly and directly supervised and controlled by their supported charity.

*2. Type II Organizations.*—Type II relationships can be more complex than the parent-subsidiary style Type I relationships, but they are still easily categorized and defined. Type II organizations must be "supervised or controlled in connection with" their supporting charities.[52] These organizations are more akin to sibling entities with a common parent, as opposed to the parent-subsidiary relationship characterizing Type I relationships. For example, a supporting organization might function as a subsidiary fundraising entity for a hospital, with both the hospital and the supporting organization overseen by a parent management company.

The regulations provide that "the distinguishing feature [of Type II organizations] is the presence of common supervision or control among the governing bodies of all organizations involved, such as the presence of common directors."[53] In Type II organizations, there must be "common supervision or control" by the leaders who oversee both the supporting organization and the supported charity.[54] Some people who have the power to manage or control the supported charity must also manage the supporting organization.[55] This common control requirement is "to insure that the supporting organization will be responsive to the needs and requirements" of the charity it supports.[56]

A supporting organization will not qualify as a Type II organization if all it does is give money to a supported charity.[57] Payment of money by a supporting organization to a charity, even when the charity can enforce the payments under state law, does not establish a significant enough connection between the two organizations to satisfy the Type II Relationship Test.[58] Type II organizations, the least common of the three types, are most commonly used by publicly

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49. *Id.* § 1.509(a)-4(g)(1)(ii).
50. *Id.*
51. *Id.*
52. *Id.* § 1.509(a)-4(a)(3).
53. *Id.* § 1.509(a)-4(f)(4).
54. *Id.* § 1.509(a)-4(h)(1).
55. *Id.*
56. *Id.*
57. *Id.* § 1.509(a)-4(h)(2).
58. *Id.*

supported charities who wish to establish a separate fund-raising arm.[59]

*3. Type III Organizations.*—Type III organizations are complex. The Type III structure provides the loosest connection between the supporting organization and its supported public charity. These organizations need only be "operated in connection with" their supported charity.[60] The regulations provide that "the distinctive feature [of Type III organizations] is that the supporting organization is responsive to, and significantly involved in the operations of, the publicly supported organization."[61] Type III organizations must, therefore, satisfy two tests: the "Responsiveness" Test and the "Integral Part" Test.[62] Complicating matters further, more liberal rules apply to grandfathered Type III supporting organizations—those operating before November 20, 1970.[63]

*a. The Responsiveness Test.*—All Type III supporting organizations must meet the Responsiveness Test in one of two ways.[64] Both ways are intended to ensure that the supporting organization will be "responsive to the needs or demands" of the charity it supports.[65]

*(i) The Significant Voice Test.*—The first way in which a supporting organization can meet the Responsiveness Test is by passing the "Significant Voice" Test.[66] Under this test, the supported charity must influence the governing board of the supporting organization using one of three possible approaches: (1) the supported charity's leaders or members ("officers, directors, trustees, or membership") must appoint or elect one or more of the supporting organization's leaders ("officers, directors, or trustees");[67] (2) one or more of the supported charity's leaders must also be a leader of supporting organization;[68] or (3) the supporting organization's leaders must "maintain a close and continuous working relationship" with leaders of the supported charity.[69] Regardless of which approach is used, the result must be that the supported charity's leaders "have a significant voice in the investment policies of the supporting organization, the timing of grants, the manner of making them, and the selection of recipients by [the] supporting organization, and in otherwise directing the use

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59. June Klaassen & Constance J. Fontaine, *Family Charitable Gifting: Private Foundations Versus Supporting Organizations*, 53 J. FIN. SERVICE PROF. 64, 69 (1999) (citing Monica Langley, *The SO Trend: How to Succeed in Charity Without Really Giving*, WALL ST. J., May 29, 1998, at A1).

60. 26 C.F.R. § 1.509(a)-4(a)(3).

61. *Id.* § 1.509(a)-4(f)(4).

62. *Id.* § 1.509(a)-4(i)(1)(i).

63. *Id.* § 1.509(a)-4(i)(1)(ii). These grandfathered organizations are permitted additional means of meeting the Responsiveness Test; "additional facts and circumstances, such as a historic and continuing relationship between organizations, may be taken into account." *Id.*

64. *Id.* § 1.509(a)-4(i)(2)(i).

65. *Id.*

66. *Id.* § 1.509(a)-4(i)(2)(ii).

67. *Id.* § 1.509(a)-4(i)(2)(ii)(a).

68. *Id.* § 1.509(a)-4(i)(2)(ii)(b).

69. *Id.* § 1.509(a)-4(i)(2)(ii)(c).

of the income or assets of [the] supporting organization."[70] All charities organized as corporations must meet this first alternative test.[71]

*(ii) The Charitable Trust Test.*—If the supporting organization is a charitable trust, it has a second way to meet the Responsiveness Test.[72] This test has three requirements: (1) the supporting organization must be a charitable trust under state law;[73] (2) the charitable trust's governing document must name the supported charity as a beneficiary;[74] and (3) the supported charity must have the right to compel an accounting and to enforce the trust under state law.[75]

*b. The Integral Part Test.*—In addition to meeting either prong of the Responsiveness Test, all Type III supporting organizations must also meet the Integral Part Test.[76] The Integral Part Test is used to determine whether the supporting organization "maintains a significant involvement in the operations" of the supported charity, and that the supported charity is "in turn dependent upon the supporting organization for the type of support which it provides."[77] In order to meet this test, the supporting organization must satisfy one of two alternative prongs: the "But For" Test or the "Substantially All Income" Test.[78]

*(i) The But For Test.*—A Type III organization can satisfy the first alternative prong of the Integral Part Test by engaging in activities "for or on behalf of" the supported charity.[79] The supporting organization must undertake these activities in order to "perform the functions of, or to carry out the purposes of [the supported charity]."[80] The crux of this test is the requirement that "*but for* the involvement of the supporting organization," the supported charity would normally engage in the activities itself.[81]

*(ii) The Substantially All Income Test.*[82]—Under the second alternative prong, the supporting organization must pay "substantially all of its income to or for the use of one or more publicly supported [charities]."[83] "Substantially all" means at least eighty-five percent of the supporting organization's net income.[84] The amount of support received by one or more of these charities must be sufficient to insure that the charity is attentive to the supporting organization's

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70. *Id.* § 1.509(a)-4(i)(2)(ii)(d).

71. The second alternative test applies only to charitable trusts. *Id.* § 1.509(a)-4(i)(2)(iii)(a).

72. *Id.* § 1.509(a)-4(i)(2)(i) and (iii).

73. *Id.* § 1.509(a)-4(i)(2)(iii)(a).

74. *Id.* § 1.509(a)-4(i)(2)(iii)(b).

75. *Id.* § 1.509(a)-4(i)(2)(iii)(c).

76. *Id.* § 1.509(a)-4(i)(1)(i).

77. *Id.* § 1.509(a)-4(i)(3)(i).

78. *Id.*

79. *Id.* § 1.509(a)-4(i)(3)(ii).

80. *Id.*

81. *Id.*

82. Some sources call this the Attentiveness Test. *See* Lapham Found. v. Comm'r, 84 T.C.M. (CCH) 586 (2002), *aff'd*, 389 F.3d 606 (6th Cir. 2004).

83. 26 C.F.R. §1.509(a)-4(i)(3)(iii).

84. Rev. Rul. 76-208, 1976-1 C.B. 161; *see also Lapham Found.*, 84 T.C.M. (CCH) 586.

operations.[85] This "attentiveness" requirement contemplates that the charity will oversee the operations of the supporting organization to ensure continued financial contributions.[86]

The regulations require that a "substantial amount" of the supporting organization's total support must be donated to those charities that meet this attentiveness requirement.[87] Further, the contribution that the supported charity receives from the supporting organization must be a significant enough portion of the charity's total support to insure that it will be attentive to the supporting organization's operations.[88] To determine whether the supporting organization's support represents a sufficient part of the supported charity's total support to ensure attentiveness, if the supporting organization "makes payments to . . . a particular department or school of a university, hospital or church, the total support of the department or school [is] substituted for the total support of the beneficiary organization."[89] For example, a supporting organization's payment to a university's law school may be a large enough portion of the law school's budget to attract the attention of the university, which may have a dozen or more such schools.

It is possible for a supporting organization to meet the Substantially All Income Test even where the amount of income the supporting organization gives to the supported charity fails to reflect a sizeable portion of its total support.[90] The Substantially All Income Test is not required if "in order to avoid the interruption of . . . a particular function or activity" made possible by the supporting organization's donations, the supported charity is "sufficiently attentive to the operations of the supporting organization."[91] Earmarking the support for a particular program or activity may have the effect of insuring this attentiveness, "even if such program or activity is not the beneficiary organization's *primary* program or activity so long as [the] program or activity is a substantial one."[92] Imagine that a supporting organization funds a visiting speaker program at a medical school. This funding might be enough to secure the school's attention even if the cost of the program were small in relation to the school's total funding. However, a supporting organization will fail to meet the Substantially All Income Test if no supported charity relies upon the supporting organization for a "sufficient amount" of its total support, even if these charities

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85. 26 C.F.R. § 1.509(a)-4(i)(3)(iii)(a).

86. *Id.*; *see also Lapham Found.*, 389 F.3d at 611. The court agreed with the tax court's finding that future contributions from a revocable trust were not enough to satisfy this part of the Attentiveness Test. *Id.* at 612. "It is difficult to believe that [the supported charity] will give [the supporting organization] the sort of regular oversight contemplated by the test when it will not be receiving substantial support from the organization for another two decades." *Id.*

87. 26 C.F.R. § 1.509(a)-4(i)(3)(iii)(a).

88. *Id.*

89. *Id.*

90. *Id.* § 1.509(a)-4(i)(3)(iii)(b).

91. *Id.*

92. *Id.* (emphasis added).

can enforce their rights against the supporting organization under state law.[93]

In determining whether the amount of support received by the charity is sufficient to insure that the charity is attentive to the supporting organization's operations, the IRS considers "[a]ll pertinent factors, including the number of [supported charities], the length and nature of the relationship between the [supported charity] and supporting organization and the purpose to which the funds are put."[94] Because a supported charity's attention is often motivated by the amount of funds received from the supporting organization, the larger the contribution (in terms of a fraction of the supported charity's total support), the more likely it is that the supported charity will be sufficiently attentive to satisfy the Integral Part Test.[95] Evidence that the supported charity is actually attentive to the supporting organization is almost as important.[96]

The regulations offer an example of sufficient evidence that a charity is actually attentive: terms requiring that the supporting organization provide the supported charity with annual reports.[97] These reports should furnish information to assist the supported charity to determine that the supporting organization's assets are invested productively, and that the supporting organization has not been indulging in activities that would trigger the private foundation excise taxes (if the supporting organization were a private foundation), like self-dealing and risky investing.[98] However, the annual report requirement is only one factor the IRS may consider in determining whether a supporting organization passes the Integral Part Test, and the lack of such a requirement is not fatal.[99]

What if a supporting organization meets the Integral Part Test, but the endowment of the charity it supports grows, such that the supporting organization's contribution is no longer the substantial portion of the charity's income that it once was? The regulations provide an exception for supporting organizations in this situation.[100] Even though a supporting organization "cannot meet the requirements . . . for its *current* taxable year solely because the amount received by [its supported charity] . . . is no longer sufficient" to fulfill the test,[101] the supporting organization will pass the Integral Part Test if it can show that it did meet the Integral Part Test for any five-year period,[102] and "[t]here has been a historic and continuing relationship of support between [the] organizations" since the end of the five-year period.[103]

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93. *Id.* § 1.509(a)-4(i)(3)(iii)(e).
94. *Id.* § 1.509(a)-4(i)(3)(iii)(d).
95. *Id.*
96. *Id.*
97. *Id.* § 1.509(a)-4(i)(3)(iii)(d).
98. *Id.*; *see also* I.R.C. §§ 4941, 4944.
99. 26 C.F.R. § 1.509(a)-4(1)(3)(iii)(d).
100. *Id.* § 1.509(a)-4(i)(1)(iii).
101. *Id.* § 1.509(a)-4(i)(1)(iii)(b) (emphasis added).
102. *Id.* § 1.509(a)-4(i)(1)(iii)(a).
103. *Id.* § 1.509(a)-4(i)(1)(iii)(c).

### *C. The Organizational Test*

After satisfying the Relationship Test, a supporting organization must also satisfy an Organizational Test. All types of supporting organizations must meet this requirement.[104] The regulations explain that a supporting organization will only meet the Organizational Test—the requirement that it be "organized . . . exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more specified [public charities]"—if its governing documents meet certain requirements.[105] The supporting organization's governing documents must: (1) "limit the purposes" of the supporting organization to charitable purposes described in the Code[106] and (2) "state the specified publicly supported [charities] on whose behalf [the] organization is to be operated."[107] The Organizational Test, therefore, has a Purpose Limitations Test and a Charity Specification Test.

*1. The Purpose Limitations Test.*—Under the Purpose Limitations Test,[108] the supporting organization's governing documents should state purposes consistent with the Code requirement that it be "organized . . . exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more specified [public charities]."[109] The supporting organization's purposes should be similar to the purposes set forth in the governing documents of the charity it supports; the purposes may be narrower than those of the charity it supports but cannot be broader.[110] A supporting organization whose articles state that it "is formed for the benefit of [a] specified publicly supported [charity]" would meet this Purpose Limitation Test.[111]

*2. The Charity Specification Test.*—Under the Charity Specification Test,[112] the supporting organization must specify in its governing documents which charities it will support,[113] and the documents cannot explicitly allow it to operate to support other entities.[114] The method of specifying a supported charity

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104. *Id.* § 1.509(a)-4(b)(1).

105. *Id.* § 1.509(a)-4(a)(2) (quoting I.R.C. § 509(a)(3)(A) (2000)).

106. *Id.* § 1.509(a)-4(c)(1)(i). The documents must also not "expressly empower the organization to engage in activities which are not in furtherance of [those] purposes." *Id.* § 1.509(a)-4(c)(1)(ii). The governing documents may include articles of incorporation, a declaration of trust, or other materials. *See id.* § 1.501(c)(3)-1(b)(2).

107. *Id.* § 1.509(a)-4(c)(1)(iii). The documents must also not "expressly empower the organization to operate to support or benefit" any other organization. *Id.* § 1.509(a)-4(c)(1)(iv).

108. *Id.* § 1.509(a)-4(c)(2).

109. *Id.* § 1.509(a)-4(a)(2) (quoting I.R.C. § 509(a)(3)(A)).

110. *Id.* § 1.509(a)-4(c)(2).

111. *Id.*

112. *Id.* § 1.509(a)-4(c)(3), (d)(1).

113. *Id.* § 1.509(a)-4(d)(1).

114. *Id.* § 1.509(a)-4(c)(3). "The fact that the actual operations of [the supporting] organization have been exclusively for the benefit of the specified [charity] shall not be sufficient to . . . meet the organizational test" if the governing documents expressly permit the support of

in the supporting organization's governing documents varies based on whether the supporting organization qualifies as a Type I, Type II, or Type III under the Type of Relationship Test.[115]

Type III organizations have a stringent standard for specifying their supported charity. The governing documents of Type III organizations must either (1) specify the supported charities by name[116] or (2) demonstrate a "historic and continuing relationship between the supporting organization" and the charity,[117] resulting in the development of a "substantial identity of interests" between the organization and the charity.[118] Type III organizations are also limited in their ability to substitute their specified charities.[119]

Type I and Type II organizations have a more generous standard than Type III organizations for specifying their supported charity. In addition to the options afforded to Type III organizations (specifying expressly by name or by a historic and continuing relationship), Type I and Type II organizations may also designate their supported charities "by class or purpose."[120] The governing documents may therefore provide that the supporting organization will "support or benefit one or more beneficiary organizations which are designated by class or purpose,"[121] including: (1) the charity that the supporting organization

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other organizations. *Id.*

115. *Id.* § 1.509(a)-4(d)(1). Thus, "[t]he manner in which the [supported charities] must be *specified* . . . will depend upon whether the supporting organization is *operated, supervised, or controlled by*[,] or *supervised or controlled in connection with*. . .[, or] *operated in connection with* . . . such [charities]." *Id.*

116. *Id.* § 1.509(a)-4(d)(2)(i).

117. *Id.* § 1.509(a)-4(d)(2)(iv)(a).

118. *Id.* § 1.509(a)-4(d)(2)(iv)(b).

119. *Id.* § 1.509(a)-4(d)(4). Assuming that the supported charity is specified by name, the governing documents of the supporting organization may

> (a) [p]ermit a [supported charity] which is designated by class or purpose, rather than by name, to be substituted for the [supported charity or charities] designated by name in the articles, but only if such substitution is conditioned upon the occurrence of an event which is beyond the control of the supporting organization, such as loss of exemption, substantial failure or abandonment of operations, or dissolution of the publicly supported organization or organizations designated in the articles; (b) [p]ermit the supporting organization to operate for the benefit of a [supported charity] which is not a publicly supported organization, but only if such supporting organization is currently operating for the benefit of a publicly supported organization and the possibility of its operating for the benefit of other than a publicly supported organization is a remote contingency; or (c) [p]ermit the supporting organization to vary the amount of its support between different designated organizations, so long as it meets the requirements of the integral part test . . . with respect to at least one beneficiary organization.

*Id.*

120. *Id.* § 1.509(a)-4(d)(2)(i)(b).

121. *Id.* § 1.509(a)-4(d)(2)(i)(b).

supports[122] or (2) charities that are "closely related in purpose or function" to that charity (or charities).[123] In accord with the more generous specification standards afforded Types I and II, these organizations can more easily substitute a specified charity than the Type III structure.[124]

### *D. The Operational Test*

In addition to meeting the various aspects of the Organizational Test, supporting organizations must also meet the Operational Test.[125] The Operational Test—which requires that a supporting organization be "*operated exclusively* to support"[126] its supported charity—requires that the supporting organization have (1) permissible beneficiaries[127] and (2) permissible activities.[128]

*1. The Permissible Beneficiaries Test.*—The Permissible Beneficiaries Test of the Operational Test is met if the supporting organization engages only in activities that benefit or support the supported charity.[129] These activities could include furnishing facilities or services, or even cash payments, to individual members of the charitable class the supported charity benefits.[130] The activities could also include contributing payments indirectly (through an unaffiliated organization) to a member of the charitable class the supported charity benefits.[131]

*2. The Permissible Activities Test.*—In order to meet the Permissible Activities Test of the Operational Test, a supporting organization need not distribute money directly to the supported charity.[132] This requirement can be met if the supporting organization merely spends its income to engage in

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122. *Id.* § 1.509(a)-4(d)(2)(i)(b)(1).

123. *Id.* § 1.509(a)-4(d)(2)(i)(b)(2).

124. *Id.* § 1.509(a)-4(d)(3)(i)-(iii). The governing documents of Type I and Type II organizations may

> (i) [p]ermit the substitution of one [supported charity] within a designated class for another [supported charity] either in the same or a different class designated in the articles; (ii) [p]ermit the supporting organization to operate for the benefit of new or additional [supported charities] of the same or a different class designated in the articles; or (iii) [p]ermit the supporting organization to vary the amount of its support among different [supported charities] within the class or classes of organizations designated by the articles.

*Id.*

125. *Id.* § 1.509(a)-4(b)(2).

126. *Id.* § 1.509(a)-4(e)(1).

127. *Id.*

128. *Id.* § 1.509(a)-4(e)(2).

129. *Id.* § 1.509(a)-4(e)(1).

130. *Id.*

131. *Id.* The payment must "[constitute] a grant to an individual rather than a grant to an organization." *Id.*

132. *Id.* § 1.509(a)-4(e)(2).

independent activities or programs that benefit the supported charity.[133] It is also appropriate for the supporting organization to raise funds for the supported charity or for permissible beneficiaries, such as by hosting fund raising dinners or soliciting contributions.[134]

### *E. The Control Test*

Once a supporting organization has passed the Organizational and Operational Tests, and all of the subtests related to its status as a Type I, Type II, or Type III organization, it still must pass a Control Test.[135] The "supporting organization may not be controlled directly or indirectly by one or more disqualified persons."[136] A "disqualified person" is any one of a list of individuals or organizations that have certain relationships with the organization.[137] Disqualified persons include the donor, certain of the donor's relatives, and businesses controlled by the donor or his relatives.[138] Publicly supported charities and managers of foundations generally are excluded from the definition of disqualified persons in this context.[139]

An organization is considered controlled if the disqualified persons can aggregate their positions of authority or their votes and cause the supporting organization "to perform any act which significantly affects its operation."[140] Generally, a supporting organization is considered controlled by disqualified persons if (1) the disqualified persons' voting power is half or more of the total voting power of the governing body of the supporting organization or (2) a disqualified person can veto the organization's actions.[141] The IRS considers "all

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133. *Id.*

134. *Id.*

135. *See* I.R.C. § 509(a)(3)(C); 26 C.F.R. § 1.509(a)-4(j).

136. 26 C.F.R. § 1.509(a)-4(j).

137. *See* I.R.C. § 4946.

138. *Id.*

139. *See* I.R.C. § 509(a)(3)(C); 26 C.F.R. § 1.509(a)-4(j)(1). But note,

> [i]f a person who is a disqualified person with respect to a supporting organization, such as a substantial contributor to the supporting organization, is appointed or designated as a foundation manager of the supporting organization by a publicly supported beneficiary organization to serve as the representative of such publicly supported organization, then for purposes of this paragraph such person will be regarded as a disqualified person, rather than as a representative of the publicly supported organization.

*Id.*

140. 26 C.F.R. § 1.509(a)-4(j)(1).

141. *Id.* The regulations provide:

> Thus, if the governing body of a foundation is composed of five trustees, none of whom has a veto power over the actions of the foundation, and no more than two trustees are at any time disqualified persons, such foundation will not be considered to be controlled directly or indirectly by one or more disqualified persons by reason of this fact alone.

pertinent facts and circumstances" to ascertain if disqualified persons do actually control the supporting organization.[142]

Notwithstanding these general guidelines that determine whether the organization passes the Control Test, an organization may provide proof of independent control.[143] The regulations provide an example: "in the case of a religious organization operated in connection with a church, the fact that the majority of the organization's governing body is composed of lay persons who are *substantial contributors*" to the supporting organization does not cause it to fail the Control Test as long as "a representative of the church, such as a bishop . . . has control over the policies and decisions of the organization."[144] Actual, independent control must be proven to the Commissioner's satisfaction.[145]

### *F. Grandfathered Supporting Organizations*

Given the intricacy of the section 509(a)(3) regulations, it is unsurprising that they were not predicted by creators of charities before the 1969 Tax Reform Act. The regulations provide that charities established before 1970 that lack the structural documentation required by current rules still will be treated as supporting organizations if they operate as such.[146] Congress imposed specific requirements on pre-1970 organizations in order to continue their tax-exempt existence as supporting organizations, and specific transitional guidelines for satisfying the Integral Part Test for Type III supporting organizations were outlined in the regulations.[147] This rule creates an entire class of supporting organizations that would be classified as private foundations if they applied for

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*Id.*

142. *Id.* The facts and circumstances to be considered will include:
the nature, diversity, and income yield of an organization's holdings, the length of time particular stocks, securities, or other assets are retained, and its manner of exercising its voting rights with respect to stocks in which members of its governing body also have some interest. Allowing a "substantial contributor" to "designate annually the recipients . . . of the income attributable to his contribution to the supporting organization" constitutes an impermissible level of control.

*Id.*

143. *Id.* § 1.509(a)-4(j)(2).

144. *Id.* (emphasis added).

145. *Id.*

146. *Id.* § 1.509(a)-4(b)(2). The regulations provide that
[i]n the case of supporting organizations created prior to January 1, 1970, the organizational and operational tests shall apply as of January 1, 1970. Therefore, even though the original articles of organization did not limit its purposes to those required under section 509(a)(3)(A) and even though it operated before January 1, 1970, for some purpose other than those required under section 509(a)(3)(A), an organization will satisfy the organizational and operational tests if, on January 1, 1970, and at all times thereafter, it is so constituted as to comply with these tests.

147. *Id.* § 1.509(a)-4(i)(4).

recognition of exempt status today.

*1. The Integral Part Test—Transitional Rules for Type III Organizations.*— Liberal requirements for meeting the Integral Part Test apply for supporting organizations established before November 20, 1970.[148] If a grandfathered supporting organization meets the requirements of the transitional rule, it need not pass all aspects of the Integral Part Test.[149] In each tax year, the trustee of a grandfathered trust must make "written reports to all of the [supported charities] . . . setting forth a description of the assets of the trust, including a detailed list of the assets and the income produced by such assets."[150]

A grandfathered supporting organization must pass five requirements. First, all of the existing interests in the trust must be devoted to one or more charitable purposes, and a deduction must have been allowed regarding these charitable interests.[151] Second, the trust must have been created before November 20, 1970, and not have received any later contributions or transfers.[152] Third, the trust's governing instrument must require the organization to make current distributions of its net income to its designated supported charity.[153] Where the supporting organization's governing instrument designates several supported charities, the supporting organization must currently distribute its entire net income in fixed portions to those supported charities.[154] Fourth, the trustee cannot have any discretion to vary either the identity of the beneficiaries or the amounts the trust pays to them.[155] Finally, no trustee may be considered to be a "disqualified person" in relationship to the trust (if the supporting organization had been

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148. *Id.*

149. *Id.* § 1.509(a)-4(i)(4)(i).

150. *Id.*

151. *Id.* § 1.509(a)-4(i)(4)(ii). A deduction must have been previously allowed under "corresponding provisions of prior law (or would have been allowed . . . if the trust had not been created before 1913)." *Id.*

152. *Id.* § 1.509(a)-4(f)(4)(i)(4)(iii).

153. *Id.* § 1.509(a)-4(i)(4)(iv).

154. *Id.* § 1.509(a)-4(i)(4)(iv). The regulations provide that

> [t]he governing instrument of a charitable trust shall be treated as requiring distribution to a designated beneficiary organization where the trust instrument describes the charitable purpose of the trust so completely that such description can apply to only one existing beneficiary organization and is of sufficient particularity as to vest in such organization rights against the trust enforceable in a court possessing equitable powers.

*Id.*

155. *Id.* § 1.509(a)-4(i)(4)(v). A trustee does not have

> such discretion where the trustee has discretion to make payments of principal to the single [charity] that is currently entitled to receive all of the trust's income[,] or where the trust instrument provides that the trustee may cease making income payments to a particular charitable beneficiary in the event of certain specific occurrences, such as the loss of exemption . . . or classification . . . by the beneficiary or the failure of the beneficiary to carry out its charitable purpose properly[.]"

*Id.*

classified as a private foundation).[156] If a supporting organization meets these criteria, it will not be categorized as a private foundation even though it does not meet the current requirements for supporting organizations.

*2. Consequences for Grandfathered Organizations.*—What are the practical consequences of being a grandfathered supporting organization? On their face, these entities may appear to be private foundations under current tax law. Trustees who are unaware of the grandfathering provision may therefore pay taxes from the charity as if it were a private foundation. Pre-1969 supporting organizations may also be structured as simple income-only trusts (e.g., pay all of the income to Samford University in perpetuity). Income-only trusts pose a variety of investment challenges.[157] When considering the complexity of supporting organizations, it is important to remember the differences of this grandfathered class; if dramatic change is made, will current organizations be grandfathered, creating three classes of organizations?

## III. BENEFITS OF SUPPORTING ORGANIZATIONS

Supporting organizations provide advantages both to those who give and those who receive. It is a useful planning tool for wealthy families seeking to meet charitable goals, and for charitable entities seeking to structure ownership of their assets efficiently. This section will discuss the benefits of supporting organizations first to donors, and then to charities.

### *A. Benefits to Donors*

The major benefit of supporting organizations to donors is that they allow charitable dollars to go further by avoiding the morass of private foundation rules and penalty taxes. This has two results: (1) fewer hindrances on administration and (2) avoidance of the excise tax on investment income.

The private foundation rules that do not apply to publicly supported charities—and supporting organizations—include restrictions on self-dealing, excess business holdings, and investments. Private foundations may not engage in transactions with "disqualified persons" (those closely associated with the foundation, such as major donors, family members, or affiliated companies).[158] They must also limit their holdings of any one security to a certain portion of their investment portfolio.[159] Private foundations are also forbidden to make "jeopardizing" investments—holdings with an unreasonable amount of risk.[160] These rules limit the way private foundations can structure their business agreements and invest their assets.

Donors to publicly supported charities also enjoy two personal income tax

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156. *Id.* § 1.509(a)-4(i)(4)(vi).

157. *See generally* Alyssa A. DiRusso & Kathleen M. Sablone, *Statutory Techniques for Balancing the Financial Interests of Trust Beneficiaries*, 39 U.S.F. L. REV. 261 (2005).

158. *See* I.R.C. § 4941 (2000).

159. *See id.* § 4943.

160. *See id.* § 4944.

advantages over donors to private foundations. The charitable deduction for gifts to publicly supported charities is capped at fifty percent of adjusted gross income,[161] as opposed to thirty percent for private foundations.[162] Gifts to public charities are also permitted to be deducted at fair market value, whereas gifts of certain kinds of property to private foundations are limited to basis.[163]

In examining the issues surrounding supporting organizations, the Panel on the Nonprofit Sector[164] has identified ways that Type III supporting organizations are "uniquely suited" to address charitable purposes.[165] The Panel suggests that Type III organizations have proven to be an excellent charitable vehicle for donors.[166] For example, donors who want to be sure that property they give is permanently dedicated to a particular charitable program or purpose of a charity can contribute the property to a Type III supporting organization with management that is independent from the supported charity.[167] Similarly, a donor who wishes to donate antiques or unique items such as collectibles can ensure that the items will remain on display instead of being sold to support the charity's other activities by utilizing a Type III supporting organization.[168] A donor can also use a Type III supporting organization where she wants to benefit several different charities that may have conflicting short- and long-term goals, because the "independent management" structure of a Type III can "effectively balance the charities' competing goals."[169]

Supporting organizations may also offer families a unique view of philanthropy, through partnership with a publicly supported charity. As one pair of advisors put it, "A family relationship with a public charity provides a pleasant and natural forum for discussion on how to use family wealth wisely."[170] Whereas private foundations may allow only minimal contacts between donors and the recipients of funds, the close relationship supporting organizations afford may help donors recognize the impact of their contributions. Supporting organizations may work best for donors in certain circumstances, including where (1) the donors have a particular public charity they want to benefit, rather than general philanthropic goals; (2) the donors are aware of individuals that they would like to serve as directors, who would not violate the control rules (perhaps a group of friends); and (3) the funding is sufficient to make a stand-alone entity

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161. *Id.* § 170(b)(1)(A).

162. *Id.* § 170(b)(1)(B).

163. *Id.* § 170(b)(1)(D).

164. The Panel on the Nonprofit Sector is a collaboration of charitable interests formed to study and report to Congress methods for improving oversight and governance of charitable organizations.

165. *See* PANEL ON THE NONPROFIT SECTOR, INDEP. SECTOR, INTERIM REPORT 42-43 (2005), *available at* http://www.nonprofitpanel.org/interim/PanelReport.pdf.

166. *Id.*

167. *Id.* at 43.

168. *Id.*

169. *Id.*

170. Klaassen & Fontaine, *supra* note 59, at 69.

worthwhile.[171]

### *B. Benefits to Charities*

Supporting organizations are created not only by individual donors, but by the publicly supported charities the organizations benefit. Charities create these entities for several reasons: efficient management of assets, segregation of functions (such as fund-raising), and asset protection. The supporting organization structure allows these benefits without subjecting the charity to the arduous task of complying with the private foundation excise tax rules.[172]

Type III supporting organizations provide unique support to charities. The Panel on the Nonprofit Sector's interim report to Congress found that Type III supporting organizations operated in connection with state universities are able "to hold and manage technology assets independently so that they are not subject to control and potential appropriation by state governments for other, unrelated state programs."[173] The Panel also reported that the Type III supporting organization structure is useful for domestic "friends" organizations of foreign public charities; the independent management structure of a Type III supporting organization is utilized so that the supporting organization can solicit U.S. contributions for the benefit of the foreign charity, without being considered a mere conduit for it.[174]

The Panel also reported how Type III supporting organizations benefit charitable institutions such as hospitals. The Panel found that "[m]any hospitals, educational institutions and other public charities are structured as networks of service providers [and not] single entities."[175] The Type III structure is important to these types of networks because frequently the parent charitable organization, which directs and provides administrative services to its subsidiaries, can only qualify for 501(c)(3) status as a Type III supporting organization.[176] This results from the fact that the parent organization controls the supported charities as opposed to being controlled by them (or under common control with them).[177]

Finally, the Panel reported that governmental entities can use Type III supporting organizations to help them advance their public purposes.[178] The Panel provided an example: when a state attorney general oversees a nonprofit hospital conversion in which the sale proceeds are used to fund a community

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171. *Id.* at 69; *see also* Victoria B. Bjorklund, *Choosing Among the Private Foundation, Supporting Organization and Donor-Advised Fund*, *in* CHARITABLE GIVING TECHNIQUES 73, 86 (Comm. on Continuing Prof'l Educ., A.L.I.-A.B.A. 2001); Gerald B. Treacy, Jr., *Supporting Organizations: A Good Alternative to Private Foundations*, 24 EST. PLAN. 17, 21 (1997).

172. PANEL ON THE NONPROFIT SECTOR, *supra* note 165, at 44.

173. *See id.* at 42-43.

174. *Id.* at 43.

175. *Id.*

176. *Id.*

177. *Id.*

178. *Id.* at 45.

foundation's supporting organization, the attorney general may recommend using a Type III supporting organization.[179] This assures that the new entity holding the assets has an independent identity from the community foundation[180] The Panel found that, in other cases, state or federal law may prohibit government-controlled entities from engaging in activities that an independent support organization could do for the benefit of the governmental entity.[181]

Clearly, supporting organizations have some benefits that other types of charities do not have. Eliminating them may cause grave loss to the philanthropic community, who will be unable to replicate the roles these charities played with other types of nonprofit entities.

### *C. Promoting Supporting Organizations Too Hard*

The unbridled enthusiasm for supporting organizations shown by some advisors is enough to give one pause. Although supporting organizations clearly have some advantages over private foundations and are a unique planning tool, they remain vehicles for charitable giving—in that the donor parts with ownership and control of the assets, which should be used to benefit charitable causes. In an attempt to sell clients on the idea of supporting organizations, some advisors have overstepped their bounds and insinuated that this type of charitable vehicle offers its donors unfettered control of donated assets.

For example, in the *CPA Journal* (published by the New York State Society of Certified Public Accountants), one CPA writes,

> Supporting organizations can be used by anyone in the high-income tax bracket who wishes to retain control of assets within the family. They can receive a 50% adjusted gross income (AGI) deduction for removing the asset ownership from their estate, yet maintain virtually the same control they had as fee-simple owners. Control can be passed down to successive generations if desired.[182]

With such promotions in the mainstream, it is no wonder donors expect an unreasonable amount of control over the assets they have donated. This expectation of control is central to the abuses perceived in the exempt organization context and will be explored more fully in the next section.

## IV. CONCERNS WITH SUPPORTING ORGANIZATION ABUSE

If you can't trust charities, who can you trust? The past few years have revealed disheartening examples of abuse of fiduciary power by leaders of both corporations and charities.[183] The corporate scandals of years past[184] were

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179. *Id.*

180. *Id.*

181. *Id.*

182. E. Kenneth Whitney, *Supporting Organizations, Sections 501(c)(3) and 509(a)(3)*, 75 CPA J. 61, 61 (2005).

183. For a review of some nonprofit scandals, see Carolyn M. Osteen et al., *Scams, Shams, and*

perhaps foreshadowing of the nonprofit scandals coming to light today.[185] In addressing scandals in the for-profit arena, the primary corrective legislation, the Sarbanes-Oxley Act,[186] focused on increased transparency and monitoring. While reformers have proposed that portions of the Sarbanes-Oxley Act be applied to nonprofits, some state legislatures are examining proposed Sarbanes-Oxley-type regulations aimed at increasing and improving nonprofit governance and accountability.[187] Scholars and lawyers alike agree that the time has come for charities to be more accountable to the public.[188]

### *A. Abuse Makes Headlines*

Contemporary concern with the abuses existing in supporting organizations was sparked by a front-page *Wall Street Journal* article in 1998.[189] Although several years have passed since the article was published, it is still cited by politicians and reformers as evidence of the need for reform. The *Journal* article called supporting organizations "a suddenly hot charitable vehicle" and exposed the actions of several supporting organizations and their famous donors, namely Carl Icahn, Gerry Spence, and David Cammack.[190]

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*Scandals—Exempt Organizations Developments in 1999*, *in* LEGAL PROBLEMS OF MUSEUM ADMIN. 369, 372 (Comm. on Continuing Prof'l Educ., A.L.I.-A.B.A. 2000).

184. Major corporate scandals of the early 21st century included WorldCom and Enron. *See, e.g.*, Peter Behr & April Witt, *Visionary's Dream Led to Risky Business: Opaque Deals, Accounting Sleight of Hand Built an Energy Giant and Ensured Its Demise*, WASH. POST, July 28, 2002, at A1; Susan Pulliam & Deborah Solomon, *Uncooking the Books: How Three Unlikely Sleuths Discovered Fraud at WorldCom*, WALL ST. J., Oct. 30, 2002, at A1.

185. For an overview of abusive tactics of directors and officers that have resulted in criminal and/or civil proceedings, see Marion R. Fremont-Smith & Andras Kosaras, *Wrongdoing by Officers and Directors of Charities: A Survey of Press Reports 1995-2002*, 42 EXEMPT ORG. TAX REV. 25 (2003).

186. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745-810 (2002).

187. *See* Wendy K. Szymanski, *An Allegory of Good (and Bad) Governance: Applying the Sarbanes-Oxley Act to Nonprofit Organizations*, 2003 UTAH L. REV. 1303, 1304-05; *see also* Jonathan Small, *Issues of Governance and Financial Management: The Impact of Sarbanes-Oxley on Nonprofits*, *in* LEGAL PROBLEMS OF MUSEUM ADMIN. (Comm. on Continuing Prof'l Educ., A.L.I.-A.B.A. 2004). "Sarbanes-Oxley principles are now very much part of the landscape of considerations nonprofits need to bear in mind in running themselves and in reporting their activities to the public and to regulators." *Id.*

188. *See* James J. Fishman, *Improving Charitable Accountability*, 62 MD. L. REV. 218 (2003); Ellen W. McVeigh & Eve R. Borenstein, *The Changing Accountability Climate and Resulting Demands for Improved "Fiduciary Capacity" Affecting the World of Public Charities*, 31 WM. MITCHELL L. REV. 119 (2004).

189. Monica Langley, *Gimme Shelter: The SO Trend: How to Succeed in Charity Without Really Giving—A 'Supporting Organization' Lets the Wealthy Donate Assets, Still Keep Control—Carl Icahn's School Project*, WALL ST. J., May 29, 1998, at A1.

190. *Id.*

Ex-corporate raider Carl Icahn was looking for a way to donate some stock, retain as much control over that stock as possible, and get the most tax-deductible bang for his buck.[191] He found it—in a Type III supporting organization. By transferring the stock to a supporting organization of his own creation, Icahn maintained control of the stock, avoided capital gains taxes, and enjoyed an income tax deduction for the full value of the assets (a perk reserved for publicly supported charities; donations to private foundations are limited by cost basis[192]).[193] Icahn claimed only one "disadvantage" of his supporting organization: sharing board membership control with a majority of "outsiders" who represent the charity's interests.[194] Icahn stated that his supporting organization will ultimately benefit underprivileged children, but initially, the result was just a healthy tax break.[195]

David Cammack amassed his wealth through real estate investment.[196] When it came time for charitable giving, Cammack wanted to share his antique car collection with a museum.[197] Instead of making an outright donation of the cars to a museum, which would give the museum total discretion to display, and the power to sell, his valuable cars, Cammack's lawyer suggested that he place the cars in a supporting organization.[198] Cammack donated three Tuckers to his supporting organization and received an immediate tax deduction for their value.[199] Cammack did not immediately part with the vehicles, primarily because he imposed conditions on his "gift" to the Antique Automobile Club of America.[200] In order to exhibit his cars, they must first build a museum to his satisfaction, complete with a Cammack family wing.[201]

Gerry Spence, a famous trial attorney, created a supporting organization to preserve his Wyoming ranch in perpetuity and to keep it out of the hands of developers.[202] The supporting organization has a relationship with the Trial Lawyers College, and the ranch is often used by fledgling lawyers as a place to become skilled in trial techniques.[203] Although the land is arguably being put to a charitable purpose, the structure allows Spence to retain significant control over his "donation."[204]

The common theme among these supporting organizations is the continued

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191. *Id.*
192. I.R.C. § 170(e)(1) (2000).
193. Langley, *supra* note 189.
194. *Id.*
195. *Id.*
196. *Id.*
197. *Id.*
198. *Id.*
199. *Id.*
200. *Id.*
201. *Id.*
202. *Id.*
203. *Id.*
204. *Id.*

amount of control exercised over assets theoretically donated to charity. Although the donors were clearly well-advised and appeared to be abiding by applicable tax rules, the transactions violate the spirit of the laws designed to encourage philanthropy. The supporting organization structure allowed these multi-millionaire donors to keep an immediate tax benefit without exhibiting a clear or immediate charitable benefit—merely minimizing taxes while continuing to control the property.

Not all practitioners believe the *Wall Street Journal* article was even-handed. An article published on the Planned Giving Design Center website noted the negative tone of the *Journal* article and expressed concern that "people will read the article (including members of Congress and their tax writing staffs) and will reach a conclusion regarding supporting organizations that does not reflect reality in most cases."[205] Limiting the ability of donors to use supporting organizations because of the wrongdoings of a few individuals can deny society of substantial philanthropic help. The flexible nature of supporting organizations appeals to successful entrepreneurs who seek to address charitable needs through their talents as well as their funds, and this may be a "boon to the future framework of the charitable world."[206] Unduly criticizing supporting organizations is not without its costs.

### *B. Simultaneous Scandals*

Around the time that the *Wall Street Journal* article made supporting organizations dinner table conversation,[207] another scandal involving supporting organizations was unfurling in the public eye. Several supporting organizations and private foundations affiliated with Reader's Digest were dismantled and their assets were distributed to public charities under the supervision of the New York State Attorney General.[208]

George Grune was the chief executive of Reader's Digest, chairman of two private foundations—the Lila Wallace-Reader's Digest Fund, Inc. and the

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205. Planned Giving Design Center, *The Supporting Organization: The Next Charitable Scapegoat?* (Mar. 17, 1999), http://www.pgdc.com/usa/item/?itemID=58145.

206. *Id.*

207. Admittedly not all families considered this to be scintillating dinner conversation.

208. For more background on the Reader's Digest charities, see Geraldine Fabrikant, *Cultural World Gets Painful Lesson in Finance*, N.Y. TIMES, Aug. 26, 1997, at D4; Joann S. Lublin & G. Bruce Knecht, *Tenure of Reader's Digest is Unabbreviated*, WALL ST. J., Jan. 9, 1998, at B1; Stacy Perman, *A Sad Story at the Digest*, TIME, Mar. 2, 1998, at 58; Linda Sandler, *Charitable Funds' Sale of Reader's Digest Shares at a Substantial Discount Is Raising Questions*, WALL ST. J., Feb. 13, 1998, at C2; Vince Stehle, *Falling Price of Reader's Digest Stock Is Big Blow to Wallace Funds*, CHRON. OF PHILANTHROPY, Feb. 26, 1998, at 21; Richard Teitelbaum, *The Plot to Shake Up Reader's Digest: A Low Stock Price Breeds No Charity*, FORTUNE, Mar. 2, 1998, at 44; *see also* Mark Rambler, Note, *Best Supporting Actor: Refining the 509(a)(3) Type 3 Charitable Organization*, 51 DUKE L.J. 1367, 1384-88 (2002) (providing an excellent discussion of the Reader's Digest scandal and citing the sources listed above).

DeWitt Wallace-Reader's Digest Fund, Inc.[209]—and a member of the board of seven supporting organizations.[210] The seven supporting organizations and the two private foundations were initially funded with Reader's Digest stock, and remained highly invested in this stock in 1996.[211] Together, the private foundations held seventy-one percent of the voting interest in Reader's Digest Association, Inc.[212] Consequently, whoever controlled the foundations controlled the company. George Grune controlled both.[213]

Throughout the late 1990s, the value of Reader's Digest stock fell precipitously, and dividends were scaled back dramatically. The stock lost about half of its value between 1992 and 1997,[214] and its dividends decreased by roughly fifty percent in July 1997.[215] Despite these losses, the supporting organizations did not diversify and saw the value of their shares plummet from $1.85 billion in 1992 to $0.7 billion in 1997.[216] Evidence suggested that the supported charities should have diversified, but George Grune's control—either direct or indirect—resulted in the supporting organizations clinging to rapidly depreciating assets.[217] Arguably, the supported charities should have had a stronger voice in the investment decisions of the supporting organizations.[218]

### *C. Loans to Donors: Abuse of a Different Color*

A 2004 *Chronicle of Philanthropy* article, *Donors Set Up Grant-Making Groups, Then Borrow Back Their Gifts,* reawakened lawmakers' attention to the abuses occurring with supporting organizations.[219] Focusing largely on shady lending transactions, the article exposed several acts of questionable legitimacy.[220]

For example, the Muralt Family Foundation was founded by a father and son

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209. Teitelbaum, *supra* note 208, at 44.

210. Perman, *supra* note 208, at 58.

211. The supporting organizations (collectively) had relationships with thirteen charities, several of which are sophisticated and well-known: Colonial Williamsburg, Macalaster College, Memorial Sloan-Kettering Cancer Center, the Metropolitan Museum of Art, the Open Space Institute, the Scenic Hudson Land Trust, Inc., the Wildlife Conservation Society, Vivian Beaumont Theater, Inc., Philharmonic-Symphony Society of New York, Inc., and the Chamber Music Society of Lincoln Center, Inc. *See* Fabrikant, *supra* note 208, at D4.

212. Teitelbaum, *supra* note 208, at 44.

213. *Id.*

214. Perman, *supra* note 208, at 58.

215. Teitelbaum, *supra* note 208, at 44.

216. Rambler, *supra* note 208, at 1385-86.

217. Perman, *supra* note 208, at 58.

218. *See* Rambler, *supra* note 208, at 1388.

219. *See* Harvey Lipman & Grant Williams, *Donors Set Up Grant-Making Groups, Then Borrow Back Their Gifts*, CHRON. OF PHILANTHROPY, Feb. 5, 2004, at 12.

220. *Id.*

to support a children's shelter.[221] After funding the Foundation with $1.4 million, however, the founders borrowed back $758,000 and used the proceeds for personal purposes.[222]

Similarly, the Hill Family Foundation was generous in making loans to its founder. The Foundation was funded with real estate sold for $225,917—the bulk of which ($220,655) was returned to Spencer Hill, the founder and donor, in two loans.[223] The funds were used to pay off the donor's personal loans and to invest in real estate.[224] Any profits from the real estate investment belonged to the donor, not to the charity.[225]

The Malecha Family Foundation also loaned the majority of its assets to its donor. Four months after its initial funding of $1,000,000, the charity loaned Mr. Malecha $800,000 of his original donation. The contribution entitled Mr. Malecha to a charitable income tax deduction even though the loan allowed him to retain the use of the majority of the funds he had contributed.[226]

A fourth supporting organization, the Rock and Terri Ballstaedt Charitable Supporting Organization, returned its entire initial funding amount of $186,000 to its donors as a loan.[227] Mr. Ballstaedt originally secured the loan with his home, but, as debts to arm's-length creditors grew, the supporting organization released the security interest, leaving the loan unsecured.[228]

The *Chronicle* reported that these lending transactions, although surprising, are not uncommon enough.[229] An examination of IRS Form 990 data exposed eighteen organizations that extended loans of $100,000 or more to officers and directors between 1998 and 2001.[230] The loans totaled over $7 million, and in a majority of the cases, the foundation loaned out over half of its assets.[231]

Lending transactions between a supporting foundation and its donors are not illegal. Although private foundation tax laws ban loans between foundations and disqualified persons, these rules do not apply to supporting organizations.[232] Entering into these transactions is not illegal, but it is not what supporting organizations were intended to accomplish.

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221. *Id.*

222. The money was used to pay off a bank loan owed by the father and to invest in real estate and business prospects. *Id.*

223. *Id.*

224. *Id.*

225. *Id.*

226. *Id.*

227. *Id.*

228. *Id.*

229. *Id.*

230. *Id.* This data has since been presented to the Senate Finance Committee. *See* Gravelle Statement, *supra* note 4.

231. Lipman & Williams, *supra* note 219, at 13.

232. *See* I.R.C. § 4941(d)(2) (2000).

### *D. Legislative Response to Abuse Begins*

After the *Wall Street Journal* and the *Chronicle of Philanthropy* brought these abuses into the spotlight, several senators initiated the reformation of supporting organizations.[233] On June 22, 2004, the Senate Finance Committee gathered a panel of experts and interested groups to testify and to discuss potential changes to the laws governing tax-exempt organizations.[234] The U.S. Senate Committee on Finance Roundtable on Tax Exemption generated not only ample concern regarding the abuses (and potential for abuse) in the supporting organization context, but it also found support for their good works and potential for accomplishing charitable goals.[235]

Mark Everson, the Commissioner of the Internal Revenue Service, testified before the Senate Finance Committee on June 22, 2004.[236] He explained the concerns relating to supporting organizations, but acknowledged the legitimate use of the structure:

> Let me emphasize here that we believe the vast majority of supporting organizations are entirely legitimate and upstanding charities. However, some tax planners see the supporting organization primarily as a means by which an organization's creator can effectively operate what would

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233. *See* Press Release, U.S. Senate Committee on Finance, Grassley, Baucus Plan to Take Aim at Abusive "Supporting Organizations" for Charities (Apr. 25, 2005) (on file with author), *available at* http://finance.senate.gov/press/Gpress/2005/prg042505.pdf [hereinafter Senate Committee on Finance Press Release]. The IRS has long been concerned with the potential for abuse in the supporting organization context. *See* Ron Shoemaker & Bill Brockner, *Control and Power: Issues Involving Supporting Organizations, Donor Advised Funds, and Disqualified Person Financial Institutions*, EXEMPT ORGANIZATIONS CONTINUING PROFESSIONAL EDUCATION PROGRAM, Part G, Sept. 6, 2000, at 107.

234. *Charity Oversight and Reform: Keeping Bad Things From Happening to Good Charities: Before the S. Comm. on Finance*, 108th Cong. (2004), *available at* http://finance.senate.gov/sitepages/hearing062204.htm [hereinafter *Hearings*].

235. *Id.* The Senate Committee on Finance convened a Roundtable to discuss proposed reforms to tax-exempt organizations. The Roundtable was held June 22, 2004, immediately after the hearing, *supra* note 234. It was closed to the public. No transcript of the Roundtable proceedings could be located. *See* U.S. Senate Committee on Finance, Press Release (2004), *Grassley Announces Participants, Releases White Papers for Charitable Governance Roundtable*, *available at* http://www.senate.gov/~finance/press/Gpress/2004/prg072104d.pdf. A collection of papers submitted to the Committee during the Roundtable is available at http://www.finance.senate.gov/sitepages/round.htm. The Roundtable, as well as the hearing, *supra* note 234, was convened in response to a bipartisan staff discussion draft concerning the need for reforms in tax-exempt organizations. *See* Staff Discussion Draft, *available at* http://www.finance.senate.gov/hearings/testimony/2004test/062204stfdis.pdf.

236. *Id.*; *see Charitable Giving Problems and Best Practices: Before the S. Comm. on Finance*, 108th Cong. (2004) (statement of Mark W. Everson, Commissioner, IRS), *available at* http://finance.senate.gov/hearings/testimony/2004test/062204metest.pdf [hereinafter Everson Statement].

> ordinarily be a private foundation under the less restrictive rules applicable to public charities. Self-dealing and certain other transactions with substantial contributors to these organizations would be prohibited in the private foundation context. However, some of the abuses and promotions we have seen clearly are not consistent with tax-exempt status.[237]

Commissioner Everson gave examples of the abuses noted:

> [I]n one promotion we have uncovered there is, almost immediately after a purported charitable donation to a supporting organization, an unsecured loan of all or a significant portion of the funds back to the donor and creator. A key part of this transaction is the effort by the promoter to ensure a lack of oversight of the supporting organization by the public charity it purports to support. While too technical to outline in this testimony, we are seeing several strategies that frustrate the ability of the supported public charity to oversee its supporting organization, clearing the way for abuses.[238]

The Senate Finance Committee Roundtable also included testimony from the charitable community, including American Hospital Association representative Dan Coleman, President and Chief Executive Officer of John C. Lincoln Health Network in Phoenix.[239] He testified about the importance of the supporting organization structure; many hospital parent corporations are structured as supporting organizations and are operated legitimately.[240] In his testimony, Mr. Coleman explained that supporting organization status is often used in the hospital context to categorize the parent corporation, to secure tax-exempt status and avoid treatment as a private foundation.[241]

Coleman acknowledged the Finance Committee's legitimate concern that the supporting organization classification has been misused.[242]

> Private individuals who are establishing and securing tax-exemptions for organizations that are not organized or being properly operated as

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237. Everson Statement, *supra* note 236, at 14.

238. *Id.*

239. *Roundtable on Tax Exemption: Before the S. Comm. on Finance*, 108th Cong. (2004) (statement of Dan Coleman, President and CEO, John C. Lincoln Health Network), *available at* http://finance.senate.gov/Roundtable/Daniel_Cole.pdf.

240. *Id.* at 3.

241. *Id.* Mr. Coleman further testified:

> In the hospital context, the supporting organization charter typically names the hospital to be benefited and, as required by IRS regulations, provides for an interlocking board of directors or management (or both) with the hospital. Supporting organizations allow hospitals to create fundraising entities with separate boards that can focus exclusively on the foundation's support mission.

*Id.*

242. *Id.*

> supporting organizations should be subject to the full enforcement power of the IRS to revoke exempt status and/or impose intermediate sanctions. . . . [A]ny proposed elimination of these supporting organizations would greatly harm hospitals.[243]

Senators Charles Grassley[244] and Max Baucus[245] wrote to the Department of the Treasury on February 3, 2005, outlining the abuses that concerned them.[246] The senators expressed concern regarding the inappropriate use of charitable organizations for purposes of tax avoidance and evasion and particularly about "charitable organizations avoiding private foundation rules by claiming public charity status as a Type III supporting organization (SO) under section 509(a)(3) of the Code."[247] The senators encouraged the Department of Treasury to revisit the regulations creating Type III supporting organizations.[248]

The U.S. Senate Finance Committee issued a press release on April 25, 2005, in which senators commented on the apparent abuses in supporting organizations.[249] The press release quoted Senator Grassley extensively:

> "This is extremely troubling," Grassley said. "Individuals are using supporting organizations to play fast and loose with the tax rules intended to help charities and encourage giving. It's clear Congress and the administration will have to take steps to stop this abuse and ensure that charitable donations benefit the needy. I'm deeply disturbed that with a good number of supporting organizations, people are taking multi-million dollar tax deductions for what they claim are contributions to charity, yet too often the result is a thimbleful of benefit to charity.
>
> "Both a Congressional Research Service report and the Finance Committee's review have made it clear that the problem isn't limited to Type III supporting organizations. The snake oil salesmen have also figured out how to manipulate Type I and II supporting organizations for the benefit of themselves and their clients. Meanwhile, the charities are lucky if they receive enough money to buy a blanket for the homeless. While the taxpayers get bilked by this abuse, sadly the needy ultimately suffer because they're denied the benefits intended by the tax law.
>
> "The law intended to allow supporting organizations only for a narrow set of circumstances. Unfortunately, creative types are exploiting a loophole in the regulations by setting up supporting organizations to skirt the laws governing private foundations. You could drive a Mack truck

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243. *Id.*
244. Senator Grassley (IA) is chairman of the Committee on Finance.
245. Senator Baucus (MT) is ranking member of the Committee on Finance.
246. Senate Committee on Finance Press Release, *supra* note 235, at 2-3.
247. *Id.* at 2.
248. *Id.* at 3.
249. *Id.* at 1-3.

through that loophole."[250]

Senator Baucus was similarly critical: "The purpose of giving taxpayers a charitable deduction is to encourage charitable works—bestowing this tax benefit is a public trust. Unfortunately, many entities organized as supporting organizations are little more than private piggy banks for greedy individuals."[251]

### *E. Judicial Examination of Supporting Organizations*

While the legislature works toward a resolution, the courts are refining the supporting organization structure bit by bit. In *Lapham Foundation, Inc. v. Commissioner*, the tax court held that a supporting organization that allegedly benefited a donor-advised fund failed several of the tests required for supporting organizations.[252]

Charles P. and Maxine V. Lapham (the "Laphams") created the Lapham Foundation (the "Foundation") in 1998. The Foundation, a nonprofit corporation incorporated in Michigan, was set up to "operate exclusively for the benefit of the American Endowment Foundation [(AEF)], a publicly supported charit[y]."[253] The Foundation's board of directors consisted of the Laphams and three other individuals, one of whom was a representative of the AEF. [254] The Foundation's only asset was a promissory note in the amount of $1,554,244, made by a corporation which the Laphams owned and which was payable to them individually.[255] The Foundation's income was to be "[d]onations from the Lapham family and its friends, including individuals and businesses," and "[i]nterest on investments."[256]

After being denied supporting organization status by the IRS, the Foundation filed a declaratory judgment action in Tax Court.[257] Because the Foundation claimed to operate in connection with a supported charity, it was analyzed under the Type III requirements.[258] The Foundation failed to meet the Attentiveness Test under the Integral Part Test for Type III organizations.[259]

The court recognized that the Foundation passed the Responsiveness Test as required for a Type III organization, but it still had to clear the Integral Part

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250. *Id.* at 1.

251. *Id.*

252. Lapham Found., Inc. v. Comm'r, 84 T.C.M. (CCH) 586 (2002), *aff'd*, 389 F.3d 606 (6th Cir. 2004); *see also* Joel Ugolini, Note, *The Difficulties of Establishing a Supporting Organization when Making Charitable Contributions to a Donor-Advised Fund Program:* Lapham Foundation Inc. v. Commissioner, 56 TAX LAW. 929, 929 (2003).

253. *Lapham Found.*, 84 T.C.M. (CCH) 586.

254. *Id.*

255. *Id.*

256. *Id.*

257. *Id.*

258. *Id.*

259. *Id.* The attentiveness requirement of the Integral Part Test is set forth in 26 C.F.R. § 1.509a-4(i)(3) (2005).

hurdle.[260] To meet the Integral Part Test, the Foundation must satisfy either the But For Test or the Attentiveness Test.[261] The Foundation fulfilled neither.[262]

In an attempt to satisfy the But For Test, the Foundation claimed that but for its involvement, the AEF would discontinue making grants to support activities in the southeastern Michigan area, the targeted area of the Lapham's charitable aims.[263] The court was quick to note that: "such grant-making activities cannot properly be characterized as something in which AEF *would be* engaged *but for* petitioner's support. Rather, distributing grant moneys is something in which AEF *is* and will continue to be engaged *regardless* of support from petitioner."[264] Thus, the Foundation failed the But For Test.[265]

The Foundation had one more chance: passing the alternative Attentiveness Test. The court analyzed the "criteria intended to cultivate attentiveness" to determine whether the Foundation's support was enough or earmarked for an essential activity so that the charity worked to ensure continued donations.[266] Initially, the court noted that "support significant in amount relative to the beneficiary's total support is generally the defining characteristic."[267] The court easily found that the Foundation's anticipated donation of $7600, when compared to the AEF's yearly donations of over $7 million, was insignificant to ensure AEF's attentiveness.[268] The Foundation also claimed that it met the second facet of the Attentiveness Test because its funds were earmarked for a substantial activity of AEF. In response, the court noted that the AEF was not required to use the Foundation's money as requested.[269]

The Foundation did not meet either alternative test of the integral part requirement.[270] The Foundation appealed to the Sixth Circuit Court of Appeals which affirmed the tax court's findings.[271]

Court guidance on qualifying supporting organizations, such as the analysis provided in *Lapham*, may help brighten the details of the supporting organization structure. Substantial reform, however, must come in the form of legislation, not litigation.

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260. *Lapham Found.*, 84 T.C.M. (CCH) at 586.

261. *Id.* The Attentiveness Test is referred to as the Substantially All Income Test in Part II of this Article.

262. *See id.*

263. *Id.*

264. *Id.*

265. *Id.*

266. *Id.*

267. *Id.* (citing 26 C.F.R. § 1.509a-4(i)(3)(iii)(d) (2005)).

268. *Id.*

269. *Id.*

270. *See id.*

271. Lapham Found., Inc. v Comm'r, 389 F.3d 606, 614 (6th Cir. 2004).

## V. POTENTIAL FOR CHANGE

The Treasury seems poised for change, and various organizations have proposed reforms that aim to curb the abuses relating to supporting organizations while preserving the form of entity as a charitable alternative. The American Bar Association, the Council on Foundations, and the Panel on the Nonprofit Sector all offered suggestions for reform.

### *A. American Bar Association*

The American Bar Association's Tax Section responded in writing to the Finance Committee Roundtable's proposal to eliminate Type III supporting organizations.[272] The Tax Section acknowledged that these organizations have been misused and that the Type III structure maintains its potential for abuse; however, the Tax Section was hesitant to support a complete elimination of Type III organizations, and it instead made several specific suggestions to reform supporting organization tax law.[273] The Tax Section believed the Type III structure's benefits outweigh its potential for abuses, noting that this structure "offers institutions and donors valuable flexibility."[274]

The Tax Section's recommendations were aimed at increasing the supported charity's involvement with the supporting organization. The Tax Section proposed that the supported charity and the Type III organization demonstrate their commitment to work together.[275] The Tax Section's recommendations included the following:

1. Require new Type III supporting organizations to include an attachment to their application for recognition of tax-exempt status (Form 1023). The attachment would include a document bearing the signature of an officer of the supporting organization stating that the charity agrees to be supported and has received copies of the supporting organization's governing documents.[276] If an officer of the supported charity has agreed to actively oversee the supporting organization's activities, that officer should also confirm that commitment on the attachment.[277]

2. Require existing Type III supporting organizations to provide a similar attachment to their annual tax filing (Form 990).[278]

3. Require Type III organizations that are organized as corporations to state

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272. *See* Letter from Richard A. Shaw, Chair of Am. Bar Ass'n Tax Section, to the Hon. Charles E. Grassley, Chairman Senate Comm. on Fin. and Hon. Max Baucus, Ranking Member of Senate Comm. on Fin. (July 19, 2004) (on file with author), *available at* http://www.abanet.org/tax/pubpolicy/2004/040719ba.pdf [hereinafter Shaw Letter]; *see also* Staff Discussion Draft, *supra* note 235, at 2.

273. Shaw Letter, *supra* note 272, at 2.

274. *Id.* at 2 app. B.

275. *Id.* at 4-5.

276. *Id.* at 2 app. B.

277. *Id.*

278. *Id.*

how often during the year the representative of the supporting organization attended board meetings or otherwise exerted influence over the supporting organization's corporations.[279] The supported organization should establish a minimum level of involvement; failing to meet this requirement could mean losing status as a public charity.[280]

4. Require all Type III organizations to report their activities annually to each public charity they support. The report should include detailed financial information so that the supported charity can "determine whether it wishes to separate itself from the Type III organization, to become more actively involved overseeing it or to take other appropriate action."[281]

5. Allow supported charities to withdraw their consent to be supported by a specific Type III organization.[282] It would be helpful if the IRS issued an information letter to charities informing them about procedures to notify the IRS of their withdrawal of consent to be named as a supported charity. This notice is important because the charity's consent to support will impact the supporting organization's tax-exempt status.[283]

The American Bar Association was not the only organization to acknowledge that problems existed and reform was needed. Other organizations answered the call for suggestions and focused on similar issues of reporting and cooperation between the supporting organization and the supported charity.

### *B. Council on Foundations*

The Council on Foundations ("Council"), a membership organization representing the interests of private foundations, also weighed in on the proposal to eliminate or to reform supporting organizations.[284] Like the ABA Tax Section, the Council recognized that abusive supporting organizations exist but was not in favor of eliminating the Type III structure.[285] Instead, the Council submitted suggestions for change, aimed at improving reporting and communication between the supporting organization and its supported charity.[286]

The Council stressed the requirement that the supported charity consent to be supported by the Type III organization.[287] In order to effectuate this demonstration of support, a new Type III organization must submit a statement

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279. *Id.*

280. *Id.*

281. *Id.*

282. *Id.*

283. *Id.*

284. Council on Foundations, Comments on Proposals in the Staff Discussion Draft Affecting Donor-Advised Funds and Supporting Organizations (Aug. 13, 2004) (on file with author), *available at* http://www.cof.org/files/Documents/Legal/2004/COFonDAF.pdf.

285. *Id.* at 13-14.

286. *Id.* at 13.

287. *Id.*

reflecting the supported charity's consent at its initial tax-exempt application.[288] Additionally, during the application phase, the Council suggested that IRS staff make *specific* inquiries to determine what efforts the supporting organization made to gain the supported charity's consent.[289] Like the ABA Tax Section, the Council suggested that the Type III organization file an annual consent statement by the supported charity, attached to the existing Form 990.[290]

The Council further suggested that the IRS issue revenue procedures through which Type III organizations can substantiate their relationship with the supported charity.[291] These procedures could require the Type III organization to send both its charity and the IRS an accounting of its annual support (or reasons for lack thereof).[292] This accounting, like the consent statement, could be attached to and filed with the Form 990.[293] In light of these consent and disclosure requirements, the Council suggested that the supported charity should be able to withdraw its consent to be supported by a Type III organization.[294] The IRS should provide procedures by which this withdrawal can be accomplished.[295]

The Council believes that these procedures, enacted by a minimal amount of legislative and regulatory overhaul, will "significantly reduce the likelihood that supporting organizations will be able to serve as vehicles for inappropriate activities."[296]

### *C. Panel on the Nonprofit Sector*

In June 2005, the Panel on the Nonprofit Sector, the panel of charitable experts charged with recommending changes to Congress and the Nonprofit Sector on Governance Transparency and Accountability, submitted its final report on Type III supporting organizations.[297] The Panel noted that while these organizations have potential for donor abuse, Type III organizations "add value to the charitable sector that cannot be replaced by other types of organizations."[298] Thus, the Panel submitted specific suggestions to Congress and the IRS aimed at deterring abuse and strengthening the relationship between

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288. *Id.*
289. *Id.* at 13 app. D.
290. *Id.*
291. *Id.*
292. *Id.*
293. *Id.*
294. *Id.*
295. *Id.*
296. *Id.*
297. *See* PANEL ON THE NONPROFIT SECTOR, STRENGTHENING TRANSPARENCY GOVERNANCE ACCOUNTABILITY OF CHARITABLE ORGANIZATIONS: A FINAL REPORT TO CONGRESS AND THE NONPROFIT SECTOR 45-48 (2005), *available at* http://www.nonprofitpanel.org/final/Panel_Final_Report.pdf
298. *Id.* at 47.

the Type III supporting organization and its supported charity. The Panel's proposals were among the most radical and required more regulatory changes than either the ABA Tax Section or the Council on Foundations.

The Panel wanted Congress to amend governing regulations to ensure that a Type III organization supports a charity, not its donors. In order to achieve this goal, all supporting organizations should be required to donate at least five percent of their net assets to supported charities annually.[299] Also, a supporting organization should not be permitted to make any grant, loan, donation, or other compensation to its donor.[300] To further discourage donor abuse, a Type III organization should be prohibited from supporting any charity or other organization controlled by its donor.[301] A Type III organization must share its governing documents and financial information with its supported charity; specifically, the supporting organization should include a detailed calculation of support and projections of support for the next year.[302] Finally, to ensure that supported charities truly benefit from their supporting organizations, a Type III organization must not support more than five charities at a time.[303]

Included in its congressional recommendations, the Panel proposed specific changes to the Responsiveness Test for trusts and corporations in order to improve their significant voice in the supported charity.[304] The Type III organization "must demonstrate a close and continuous relationship with the governing board or officers of the supported organizations."[305] This would require an "actual operating relationship[] between the managers" of the Type III organization and its charity.[306] The amended regulations should also specify how supporting organizations can demonstrate this significant voice factor.[307]

The Panel also submitted specific recommendations to the IRS to improve the relationship between the supporting organization and its charity, and to help discourage abuse. The IRS should:

1. Revise Form 990 so supporting organizations can indicate whether they qualify as Type I, II, or III,[308] and;

2. Require every Type III organization to submit a letter from each charity it supports.[309] The letter should be submitted at the initial application as well as filed annually with the Form 990.[310] The supported organization must verify its consent to be supported and describe how the supporting organization provides

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299. *Id.* at 45.
300. *Id.*
301. *Id.*
302. *Id.*
303. *Id.*
304. *Id.* at 46.
305. *Id.* at 45-46.
306. *Id.* at 48.
307. *Id.* at 46.
308. *Id.*
309. *Id.*
310. *Id.*

support that "furthers the charitable purposes of the supported organization."[311]

### *D. Looking Beyond the Supporting Organization Regulations for Reform*

The suggestions of the American Bar Association, Council on Foundations, and Panel on the Nonprofit Sector may well reduce abuses in the supporting organization context. Increasing IRS filings and requiring better communication between the supporting organization and the supported charities may serve to discourage noncompliance with the spirit of the supporting organization regulations.

Targeted anti-abuse rules, accompanied by penalties, should help to close the loopholes that permit self-dealing. Expanding the supporting organization regulations, however, adds complexity to a system that is already "fantastically intricate."[312] In addition to examining the supporting organization regulations themselves and to increasing Form 990 filing requirements, reformers should look beyond the immediate context of supporting organizations and consider the broader mechanisms for monitoring charitable behavior.

## VI. A NEW SUGGESTION FOR REFORMING SUPPORTING ORGANIZATIONS

Why do some people (and the organizations they control) misbehave and exploit opportunities for abuse, and why, conversely, do others choose to behave properly and observe the rules? The choices individuals make are complex, but one thing is clear—people behave better when they are afraid of being caught.

The great philosopher Michel Foucault has theorized that actual observation is not necessary to motivate a person to regulate his own behavior; the mere *belief* that one is being watched is enough to promote obedience.[313] According to Foucault, regulation of societal behavior is based on surveillance.[314] His classic example is Jeremey Bentham's Panopticon.[315] The Panopticon was an eighteenth century prison design in which cells were monitored from a central tower.[316] This design prevented the prisoner from determining whether anyone was watching him.[317] The prisoner's behavior was therefore regulated, not by guards, but by the prisoner's subjective vulnerability to being watched.[318] Modern psychological research supports this theory: people simply are more inclined to regulate their behavior when they believe they are under

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311. *Id.*

312. Windsor Found. v. United States, No. 76-0441-R, 1977 U.S. Dist. LEXIS 13643, at *5 (E.D. Va. Oct. 4, 1977).

313. *See* MICHEL FOUCAULT, DISCIPLINE AND PUNISH: THE BIRTH OF THE PRISON 201-03 (Random House 1977) (1975).

314. *Id.*

315. *Id.* at 200.

316. *Id.*

317. *Id.* at 201.

318. *Id.*

surveillance.[319]

Lawmakers are aware of the phenomenon that monitoring—or the risk that activities may be monitored—encourages compliance with rules. Charities, including supporting organizations, are subject to the public disclosure regulations of section 6104(d) of the Internal Revenue Code.[320] These regulations require charities to reveal their informational returns, which include detailed financial information about the organization, to members of the public.[321] The disclosure of this information increases the probability that improper financial dealings will be revealed because the public and media, in addition to the IRS, may access this information. The public disclosure requirements of section 6104 mandate that a qualified organization make the following documents available for public inspection or provide copies upon request: the organization's annual return, exempt status application materials, exempt status notice materials, and reports of the organization's expenditures and contributions.[322]

The public disclosure requirements dramatically increase the probability that the public and the media will have access to a charity's records and thus misdeeds will not pass unnoticed.[323] Members of the public are more likely to seek out records of the publicly supported charities to which they have donated or from which they have sought services, and thereby monitor the charities themselves. But will the public also monitor the charities' supporting organizations? Section 6104 public disclosure requirements apply to supporting organizations in the same manner as all other tax-exempt organizations.[324] The truth is out there—but are people finding it?

By all appearances, the actions of supporting organizations are not heavily

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319. *See* Jeffrey H. Reiman, *Driving to the Panopticon: A Philosophical Exploration of the Risks to Privacy Posed by the Highway Technology of the Future*, 11 SANTA CLARA COMPUTER & HIGH TECH. L.J. 27, 41 (1995) ("To the extent that a person experiences himself as subject to public observation, he naturally experiences himself as subject to public review. As a consequence, he will tend to act in ways that are publicly acceptable."); *see also* Christopher Slobogin, *Public Privacy: Camera Surveillance of Public Places and the Right to Anonymity*, 72 MISS. L.J. 213, 243-45 (2002).

320. I.R.C. § 6104(d) (2000). Certain types of charities, such as hospitals and other health care organizations, are also regulated outside of the tax system. *See* William M. Sage, *Regulating Through Information: Disclosure Laws and American Health Care*, 99 COLUM. L. REV. 1701 (1999) (discussing how transparency and disclosure are used to regulate the healthcare industry).

321. *Id.*; *see also* Sage, *supra* note 320, at 1810.

322. I.R.C. § 6104(d).

323. *See* Susan N. Gary, *Regulating the Management of Charities: Trust Law, Corporate Law, and Tax Law*, 21 U. HAW. L. REV. 593, 640 (1999). In favor of increased public disclosure to aid in protecting charities against fiduciary abuse, Gary noted that "[e]asier public access to information, more effective disclosure, and for certain transactions, increased disclosure, will help." *Id.* at 639.

324. 26 C.F.R. § 301.6104(d)-1(b)(2) (2005); *see also* Shoemaker & Brockner, *supra* note 233, at 119.

monitored. The potential for abuse in the supporting organization context stems in part from the method by which these organizations are overseen. Private foundations are overseen by the IRS.[325] Publicly supported charities are overseen by their donors and the general public.[326] Who oversees supporting organizations?

The structure of the supporting organization regulations assumes that the supported charity will act as a check on the supporting organization's behavior.[327] The supported charity itself has an economic interest in the affairs of the supporting organization, and it should, by the structure of the relationship, pay attention to the activities of the supporting organization. The supported charity, however, bears no responsibility for overseeing the supporting organization, and it suffers no legal or tax consequence if it chooses to neglect it. The supported charity has no duty to oversee.

Supported charities garner substantial benefit from the tax treatment of supporting organizations. If supporting organizations were abolished, the founders of these charities would likely create private foundations—subject to greater tax, but free from the ties to specific publicly supported charities. Although they are under no express duty to oversee them, supported charities are best served by maintaining the existence of 509(a)(3) organizations.

The supported charities, however, are obtaining these benefits without sufficient concomitant responsibility. The system is designed such that the supported charities are expected to be aware of and react to the activities of the supporting organizations.[328] Unfortunately not all do. When supporting organizations are managed improperly, insufficient oversight and low risk of exposure may be the reasons. Aside from the risk of financial loss arising from the supporting organization's wrongdoing, a risk that is in some cases insufficient, the supported charities have no responsibility for the actions of their supporting affiliate.

In banking law, the Office of the Comptroller of the Currency identifies certain types of risk that financial institutions must manage.[329] This concept of risk can also inform decisions about how to motivate the proper oversight of supporting organizations. Two relevant categories of risk are compliance risk

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325. *See* I.R.C. § 6104.

326. But whose public does a charity serve? *See* Brody, *supra* note 29, at 1036 (arguing that "this decision is legitimately made by private parties—donors, charity boards, and members—and so a charity's public is not necessarily the local community, the state, or any other public that constitutes the constituents of an attorney general, a legislature, or a judge").

327. *See* 26 C.F.R. § 1.509(a)-(4)(i)(3)(iii)(d).

328. *See* Quarrie Charitable Fund v. Comm'r, 603 F.2d 1274, 1277-78 (7th Cir. 1979).

329. A "risk" is the potential for an event, arising from the business of banking, that would seriously damage a bank. *See, e.g.*, COMPTROLLER OF THE CURRENCY, DETECTING RED FLAGS IN BOARD REPORTS, A GUIDE FOR DIRECTORS 2 (2003), *available at* http://www.occ.treas.gov/rf_book.pdf (listing nine categories of risk: "credit, liquidity, interest rate, price, foreign currency translation, compliance, strategic, reputation, and transaction").

and reputational risk.[330] Compliance risk (also called legal risk) is "the risk to earnings or capital arising from violations of, or nonconformance with, laws, rules, regulations, prescribed practices, or ethical standards[,]" and reputational risk is "the risk to earnings or capital arising from negative public opinion."[331]

As the rules currently stand, supported charities bear no substantial compliance risk or reputational risk for the actions of their supporting organizations. Requiring the supported charity to be responsible for complying with the public disclosure rules for materials of their affiliated supporting organizations increases reputational risk to the supported charity. It also creates compliance risk, because the supported charity risks violating a tax regulation if it fails to collect and publicize the informational returns of the supporting organization. Sensitivity to the added reputational risk and compliance risk will motivate the supported charity to properly oversee the supporting organization.

It is time for supported charities to partner with the public in monitoring the actions of their supporting organizations. As the beneficiaries of the supporting organizations, supported charities are in a strong position to collect information about supporting organizations' activities and finances. Perhaps more importantly, the supported charities are visible establishments capable of garnering public attention and have the ability to *publish* that information. There is a gap between the activities of anonymous supporting organizations and the public; the supported charities are the bridge.

Supported charities should be required to disclose the information returns of their affiliated supporting organizations. The public disclosure regulations should be amended to require supporting organizations to disclose their materials two ways: directly and through their supported charities. A proposed addendum of a new final paragraph (subsection (9)) to the public disclosure regulations,[332] could read as follows:

> (9) *Special rules for organizations defined in section 509(a)(3) and organizations receiving support from organizations defined in section 509(a)(3).* An organization referred to in section 509(a)(3), hereinafter called a "supporting organization," shall, in addition to complying with paragraph (1) above, provide all materials described in paragraph (1) above to any organization it supports (within the meaning of section 509(a)(3) (hereinafter called a "supported charity")). A supported charity shall in turn disclose the materials described in paragraph (1) above relevant to those supporting organizations. A supported charity shall disclose the materials of its affiliated supporting organizations in the same manner it discloses its own materials, and the above rules and

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330. *Id.*

331. COMPTROLLER OF THE CURRENCY, BANK SUPERVISION PROCESS, COMPTROLLER'S HANDBOOK 21 (1996), *available at* http://www.occ.treas.gov/handbook/banksup.pdf. *See generally* FEDERAL RESERVE: BANK HOLDING COMPANY SUPERVISION MANUAL (2004), *available at* http://www.federalreserve.gov/boarddocs/supmanual/bhc/bhc0604.pdf.

332. *See supra* notes 320-22 and accompanying text.

> procedures shall apply equally to materials of the supported charity itself and those of its affiliated supporting organizations. The supporting organization shall reimburse the supported charity for its actual costs in complying with the disclosure requirement relative to the supporting organization.

The enactment of this additional disclosure requirement would dramatically increase the visibility and transparency of informational returns of supporting organizations. Members of the public are unlikely to troll the Internet for information on nameless supporting organizations, but they are more likely to review the financial information of charities to which they donate. When donors receive information about their charity, revealing the existence of affiliated supporting organizations, the donors (and the media) are more likely to explore the supporting organization's materials as well.

The availability of this information is increasing as charities choose to comply with the disclosure requirement through web posting on sites such as Guidestar.[333] The *Chronicle of Philanthropy* story on supporting organization abuse broke based upon information available on Guidestar. Perhaps if supporting organization returns were more widely posted on the web, they would be subject to greater exposure and greater monitoring. Supported charities could simply provide a link to supporting organization materials on the website where they post their own.

Reforming public disclosure requirements to increase the number of people who are likely to see the financial returns is an important first step. Additional steps should be taken, however, to insure that what is being disclosed, and the form in which it is communicated, is helpful to readers. As Nina Crimm has argued, "[t]o enhance the standards of accountability, states and the federal government should consider reforming the types of information and format of data required to be disclosed at foundations' formation, application for tax-exempt status, and annually thereafter."[334] There is much work to be done in improving institutional transparency and accountability.[335] Broader disclosure of supporting organization returns is progress toward this goal.

The drawback to revising the public disclosure rules is that it adds further burden and complexity to a heavily regulated sector. Over-regulation may backfire: "decision-makers of organizations that operate in regulatory environments, particularly in over-regulated environments such as those created

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333. Guidestar is a website run by Philanthropic Research Institute, Inc., a nonprofit corporation. The website provides information on charities (including tax returns). *See* www.guidestar.org (last visited Feb. 21, 2006).

334. Nina J. Crimm, *A Case Study of a Private Foundation's Governance and Self-Interested Fiduciaries Calls for Further Regulation*, 50 EMORY L.J. 1093, 1188 (2001).

335. *See* Frances R. Hill, *Targeting Exemption for Charitable Efficiency: Designing a Nondiversion Constraint*, 56 SMU L. REV. 675, 717 (2003) ("The nondiversion constraint . . . provid[es] the basis for operational transparency. . . . [and] establishes a workable framework for meaningful participation and accountability within exempt organizations.").

in the area of taxation, unfortunately may establish institutional standards and systems primarily focused on minimal satisfaction of the regulatory requirements rather than guided by an enthusiastic promotion of their purposes."[336] The additional regulatory burden here, however, is minimal compared to the alternative solutions.

The reports of supporting organization abuse are serious, and a serious response is needed. When supported charities abide by the proposed enhanced public disclosure rules with respect to their affiliated supporting organizations, the increased public scrutiny will encourage sounder compliance with existing tax laws. If, however, abuses continue—and the choice is to either eliminate Type III supporting organizations or to find a way to control them—the Treasury should consider enacting regulations that require the supported charity not only to participate in the public disclosure process, but to assume full responsibility for monitoring the activities of the supporting organization affiliated with it.

## CONCLUSION

Supporting organizations are versatile and efficient vehicles for managing wealth for charitable purposes. They are also susceptible to abuse and over-reaching control. For supporting organizations to flourish in the current environment of institutional skepticism, they must submit to greater levels of transparency.

The supporting organization structure is not broken. Although complex, the rules surrounding supporting organizations are logical and were designed to enable the operation of a special kind of charity—one that does not fit soundly in the categories of public charity or private foundation. The intricate structure of the supporting organization rules relies upon the charities with which the supporting organizations affiliate to serve as checks on the supporting organization. The trouble and scandals emerging with respect to supporting organizations do not stem from the fact that these organizations are inherently bad or subject to abuse, but from the fact that they are not being overseen as originally designed.

The current supporting organization regulations and their historical enactment suggest a presumption that supporting organizations do not require the oversight of the IRS—and the more stringent rules that apply to private foundations—because of their close working relationship with publicly supported charities. Publicly supported charities are monitored by their donors, and the charities in turn are expected to monitor the activities of their affiliated supporting organizations.

Resting full responsibility for the oversight of supporting organizations on the charities they support may be a burdensome solution, but the cooperation of the supported charities in increasing public surveillance is a reasonable

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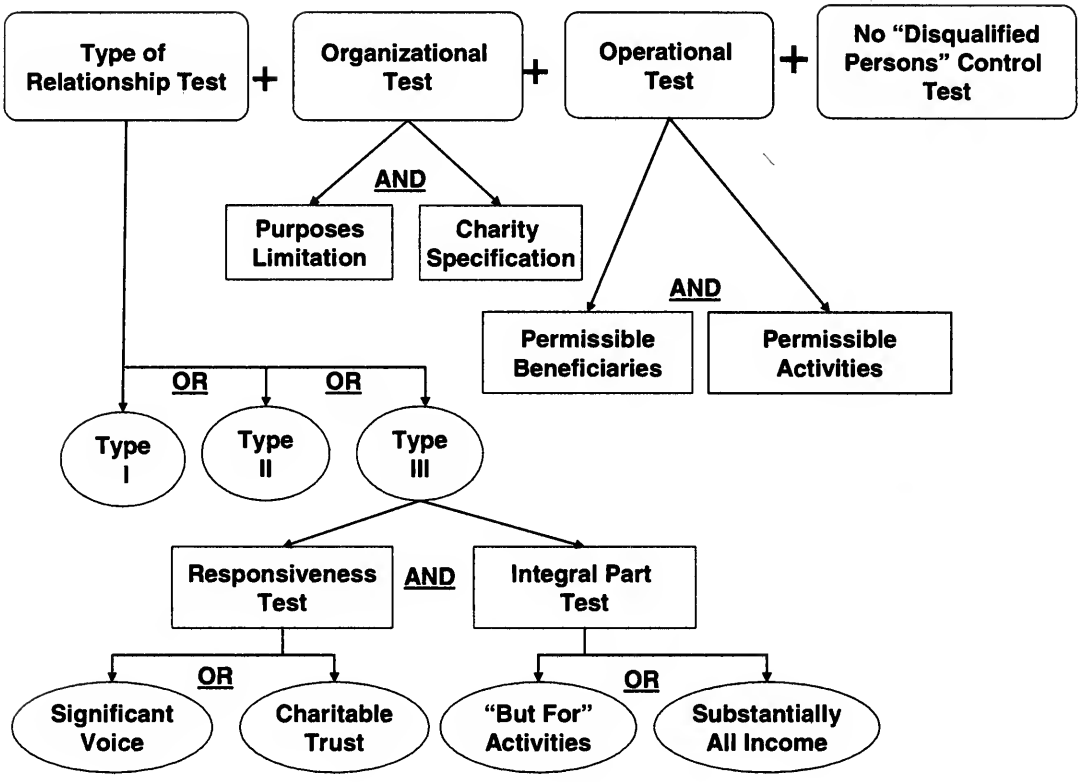
336. Nina J. Crimm, *Through A Post-September 11 Looking Glass: Assessing the Roles of Federal Tax Laws and Tax Policies Applicable to Global Philanthropy by Private Foundations and Their Donors*, 23 VA. TAX REV. 1, 154 (2003).

responsibility. Supported charities must assist the public and the media to monitor the actions of these supporting organizations, and they can most effectively cooperate with the public by sharing information. Amending the public disclosure regulations to require supported charities to disclose the information returns of the supporting organizations with which they affiliate will increase the transparency of supporting organizations. It will also result in wider availability of this information and help to insure that the supporting organizations behave ethically and appropriately.

Charity is a virtue, but not all charities are virtuous. In developing the notion of charitable accountability, transparency is essential. In the context of supporting organizations, transparency can transform a charitable structure plagued by exploitation into a philanthropic tool full of potential.

## Appendix A
Supporting Organization Structure



# "CAN YOU HEAR ME NOW?": EXPECTATIONS OF PRIVACY, FALSE FRIENDS, AND THE PERILS OF SPEAKING UNDER THE SUPREME COURT'S FOURTH AMENDMENT JURISPRUDENCE

DONALD L. DOERNBERG*

## INTRODUCTION

The Fourth Amendment[1] has given the Supreme Court and scholars trouble since the Court began paying serious attention to it in 1886.[2] The problems begin with its wording:

> The right of the people to be secure in their persons, houses, papers, and effects against unreasonable searches and seizures, shall not be violated, and no Warrants shall issue, but upon probable cause, supported by Oath or affirmation, and particularly describing the place to be searched, and the persons or things to be seized.[3]

For adherents of black-letter law and bright-line tests, the Fourth Amendment presents a disconcerting challenge. After all, how much certainty and clarity can one expect from an amendment that speaks in terms of reasonableness and probability? Oddly, the Court's early approaches to the Amendment were a blend of sweeping vision and mechanical application. One would search in vain for more lofty statements about privacy interests and suspicion of government power than those in *Boyd v. United States*.[4] Justice Bradley, writing for the Court, quoted extensively from Lord Camden's famous opinion in *Entick v. Carrington*[5]

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* Professor of Law, Pace University. B.A. 1966, Yale University; J.D. 1969, Columbia University.

Special thanks go to my colleague, Professor Barbara Black, a specialist in corporations and securities regulation law (of all things), whose thoughtful questions and observations in casual conversation one day provoked me to better understand what is really going on beneath the surface of the Supreme Court's jurisprudence in this area. I also appreciate Professor Bennett Gershman's willingness to read a draft and his helpful comments and suggestions.

I also am delighted to acknowledge my gratitude to and respect for Elizabeth Wheeler, Pace University School of Law Class of 2006, and Sara Miro and Saad Siddiqui, Pace University School of Law Class of 2007, for their dedicated research and editing assistance. My thanks also to Jennifer Odrobina, Pace University School of Law Class of 2005, for her thoughtful comments on the manuscript. Finally, I would like to thank the editors and staff of the Indiana Law Review for their hard work and help. The Article is better for their efforts. The errors that remain reflect my ability to overcome their good counsel.

1. U.S. CONST. amend. IV.

2. *See* Boyd v. United States, 116 U.S. 616 (1886). Only three Supreme Court cases before *Boyd* even mention the Fourth Amendment specifically; none discusses it at any length. *See generally* WAYNE R. LAFAVE ET AL., CRIMINAL PROCEDURE § 3.1, at 106 (4th ed. 2004) (noting that "[t]he Fourth Amendment remained largely unexplored until 1886").

3. U.S. CONST. amend. IV.

4. 116 U.S. 616 (1886).

5. (1765) 95 Eng. Rep. 807 (K.B.), *quoted in Boyd*, 116 U.S. at 627-28:

about the inviolability of individuals' houses and personal papers.

> The principles laid down in this opinion affect the very essence of constitutional liberty and security. They reach further than the concrete form of the case then before the court, with its adventitious circumstances; they apply to all invasions on the part of the government, and its employés of the sanctity of a man's home and the privacies of life. It is not the breaking of his doors, and the rummaging of his drawers, that constitutes the essence of the offense; but it is the invasion of his indefeasible right of personal security, personal liberty and private property, where that right has never been forfeited by his conviction of some public offense,—it is the invasion of this sacred right which underlies and constitutes the essence of Lord CAMDEN's judgment. Breaking into a house and opening boxes and drawers are circumstances of aggravation; but any forcible and compulsory extortion of a man's own testimony, or of his private papers to be used as evidence to convict him of crime, or to forfeit his goods, is within the condemnation of that judgment.[6]

One should note, however, that *Boyd* and its soaring statements of "sacred right" have fallen upon hard times. For example, the Court has permitted the state to compel defendants to give voice[7] or handwriting exemplars,[8] to have their blood tested for alcohol content,[9] or to turn over private papers.[10] All of these aid in the process of securing convictions. The Court has explained, however, that the Fourth Amendment does not protect things (such as one's voice or handwriting) that are constantly exposed to the public, and the Fifth Amendment protects only against evidence that is both compelled and testimonial.

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> Papers are the owner's goods and chattels; they are his dearest property; and are so far from enduring a seizure, that they will hardly bear an inspection; and though the eye cannot by the laws of England be guilty of a trespass, yet where private papers are removed and carried away the secret nature of those goods will be an aggravation of the trespass, and demand more considerable damages in that respect. Where is the written law that gives any magistrate such a power? I can safely answer, there is none; and therefore it is too much for us, without such authority, to pronounce a practice legal which would be subversive of all the comforts of society.

6. *Boyd*, 116 U.S. at 630.

7. *See* United States v. Dionisio, 410 U.S. 1, 13-14 (1973) (finding that a grand jury subpoena requiring voice exemplar does not violate either the Fourth or Fifth Amendment).

8. *See* United States v. Mara, 410 U.S. 19, 21-22 (1973) (finding that a grand jury subpoena requiring handwriting exemplar does not violate the Fourth or Fifth Amendment and that the government need not show reasonableness).

9. *See* Schmerber v. California, 384 U.S. 757, 765, 772 (1966) (explaining that a warrantless taking of a blood sample to determine whether defendant drove while intoxicated does not implicate the Fifth Amendment and presents no Fourth Amendment problem if there is a "clear indication" of intoxication and police officer had probable cause to detain defendant).

10. *See* Couch v. United States, 409 U.S. 322, 329 (1973) (finding that a taxpayer's papers given to an accountant were not within Fifth Amendment privilege).

Nonetheless, the Fourth Amendment continues to receive some deference from the Court, which seemed to expand the Amendment's reach in 1967 by beginning to focus on individuals' "reasonable expectation of privacy" as the touchstone for Fourth Amendment protection rather than property concepts such as trespass.[11] It turns out, though, that in many situations there is rather less to the expectation of privacy than meets the eye. The Court's pronouncements about when a subjective expectation of privacy is reasonable sometimes appear to diverge from the public's ideas. In the false-friend cases,[12] the Court has ruled that evidence revealed to the government by a confidant of the defendant is admissible precisely because there is no reasonable expectation of privacy in such situations.[13] In so ruling, the Court raises more (and more troubling) questions than it answers. First, how should the Court determine what constitutes a reasonable expectation of privacy? Second, what are the implications of the rulings in the false-friend cases that there is no reasonable expectation of privacy when voluntarily divulging information to another? Third, why does the Court espouse a concept of consent so at variance with the law's view of consent in other common contexts? This Article discusses those issues, concluding that the Court, perhaps unwittingly, has articulated a rationale that would permit the government unrestricted interception of communications without any Fourth Amendment limitations.

Part I offers a brief history of the development of Fourth Amendment jurisprudence and the Court's articulation and application of what has come to be known as the exclusionary rule, which forbids some (but not all) government use of evidence seized in violation of the Fourth Amendment. Part II focuses on the false-friend cases, elaborating the Court's reasoning and showing why, although the most famous cases involve varying kinds of activity from electronic recording to eavesdropping to simple reporting of the false friend's observation, the Court's method has united these cases under a single analytical rubric. Part III discusses the unavoidable implication of the Court's approach, and Part IV examines whether there is a principled way out of the dilemma that the Court's reasoning has created. It concludes that there is, but the solution requires recognizing two unstated assumptions that undergird the Court's jurisprudence in this area, assumptions that, when exposed to light, are highly questionable. The Court needs to reconsider how expectations of privacy really work. It has tended to view expectation of privacy as an all-or-nothing proposition, so that for Fourth Amendment purposes, lack of a reasonable expectation of privacy with respect to one person connotes that there cannot be a reasonable expectation with respect

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11. *See* Katz v. United States, 389 U.S. 347, 360 (1967) (Harlan, J., concurring); *see also infra* notes 77-91 and accompanying text.

12. With respect to the Fourth Amendment, the term first appeared in *On Lee v. United States*, 343 U.S. 747, 757 (1952): "The use of informers, accessories, accomplices, false friends, or any of the other betrayals which are 'dirty business' may raise serious questions of credibility."

13. *See, e.g.*, United States v. White, 401 U.S. 745 (1971); Hoffa v. United States, 385 U.S. 293 (1966); Lewis v. United States, 385 U.S. 206 (1966); *On Lee*, 343 U.S. 747; *see also infra* notes 125-79 and accompanying text.

to anyone else.[14] The Article suggests that this approach does not reflect the way that either those who wrote and ratified the Fourth Amendment or the majority of Americans today think about privacy. The Supreme Court should recognize, therefore, that when the government employs false friends to gather evidence for use in a criminal case, it does no more than to undertake a search with other eyes and ears and a seizure with other hands. It is a government intrusion all the same. Accordingly, the Fourth Amendment's warrant requirement, which demands probable cause and the acquiescence of a neutral magistrate in the proposed search, should apply in full force.[15]

## I. THE DEVELOPMENT AND EARLY HISTORY OF THE EXCLUSIONARY RULE

No constitutional provision is immune from violation. With respect to the Fourth Amendment, the question for the Supreme Court became what to do after a violation had occurred. The Court's answer, now widely known, was to render inadmissible testimony based upon an unconstitutional search or seizure and to exclude any material seized as a result of the unconstitutional activity—the now familiar exclusionary rule. Although *Weeks v. United States*[16] and *Mapp v. Ohio*[17] are the cases most often associated with the Court's announcement of the rule (*Weeks* imposed the rule in the federal courts and *Mapp* extended it to the states), the Court actually first confronted the problem eighteen years before *Weeks*, in *Boyd v. United States*.[18]

The United States charged Boyd with customs violations relating to the importation of thirty-five cases of plate glass, the value of which (and therefore the duty owed) was in dispute. The government obtained a court order directing Boyd to produce the invoice from an earlier importation of twenty-nine cases of glass. Boyd produced the invoice under protest, arguing that compelled production of the evidence violated both the Fourth and Fifth Amendments.[19] The Supreme Court upheld Boyd's claim, in the process recalling matters from the colonial period that provided the impetus for adoption of the Fourth Amendment.[20] Then the Court prescribed the remedy: exclude the evidence and

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14. *See infra* text accompanying notes 103-08.

15. There is a well-recognized exception to the warrant requirement if "exigent circumstances" are present that make it impracticable to obtain a warrant. *See, e.g.*, Warden v. Hayden, 387 U.S. 294, 299 (1967) (involving a hot pursuit of an armed robber, which made warrantless search for weapons and perpetrator of house into which he fled permissible); Schmerber v. California, 384 U.S. 757, 770-71 (1966) (finding a warrantless blood alcohol test permissible because metabolic process would otherwise have destroyed evidence of intoxication before a warrant became obtainable). Almost by definition, however, the false-friend cases involve government planning, not exigency.

16. 232 U.S. 383 (1914).

17. 367 U.S. 643 (1961).

18. 116 U.S. 616 (1886).

19. *Id.* at 617-18.

20. The *Boyd* Court noted that

remand for a new trial without the tainted evidence.[21] Although the Court did not use the word "suppression," it is clear that it meant precisely that. The *Boyd* result was unanimous. Justice Miller, joined by Chief Justice Waite, concurred. He agreed that the proceedings had violated Boyd's Fifth Amendment rights by compelling his assistance in his prosecution but disagreed on the Fourth Amendment question, refusing to view the lower court's order compelling production of the document and Boyd's subsequent compliance as a search within the meaning of the Fourth Amendment.[22] More significantly, though, Justice Miller did agree that the proper remedy was a new trial without the tainted evidence; his disagreement was limited to the constitutional designation of the taint.[23]

*Boyd* did not, however, settle the question of what to do about constitutional violations in the course of investigation and prosecution of crime. *Adams v. New York*[24] involved the seizure of illegal gambling slips and some personal papers[25]

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> [i]n order to ascertain the nature of the proceedings intended by the [F]ourth [A]mendment to the [C]onstitution under the terms "unreasonable searches and seizures," it is only necessary to recall the contemporary or then recent history of the controversies on the subject, both in this country and in England. The practice had obtained in the colonies of issuing writs of assistance to the revenue officers, empowering them, in their discretion, to search suspected places for smuggled goods, which James Otis pronounced "the worst instrument of arbitrary power, the most destructive of English liberty and the fundamental principles of law, that ever was found in an English law book;" since they placed "the liberty of every man in the hands of every petty officer." This was in February, 1761, in Boston, and the famous debate in which it occurred was perhaps the most prominent event which inaugurated the resistance of the colonies to the oppressions of the mother country. "Then and there," said John Adams, "then and there was the first scene of the first act of opposition to the arbitrary claims of Great Britain. Then and there the child Independence was born."

*Id.* at 624-25 (footnote omitted).

21. The *Boyd* Court held that

> [w]e think that the notice to produce the invoice in this case, the order by virtue of which it was issued, and the law which authorized the order, were unconstitutional and void, and that the inspection by the district attorney of said invoice, when produced in obedience to said notice, and its admission in evidence by the court, were erroneous and unconstitutional proceedings. We are of opinion, therefore, that the judgment of the circuit court should be reversed, and the cause remanded, with directions to award a new trial; and it is so ordered.

*Id.* at 638.

22. *Id.* at 639-40 (Miller, J., concurring).

23. *Id.* at 639-41.

24. 192 U.S. 585 (1904).

25. The prosecution used defendant's private (but legal) papers both to establish that the office searched was the defendant's and for comparison purposes to show that the handwriting on the gambling slips was his. *See* People v. Adams, 68 N.E. 636, 637 (1903), *aff'd*, 192 U.S. 585 (1904).

of the defendant from his office when the police arrived to execute a search warrant that they claimed to have.[26] At his trial for violating New York's gambling laws, Adams argued that the seizure violated his rights under the Fourth and Fifth Amendments and under corresponding provisions of the New York Constitution. When the case reached the Supreme Court, the Justices unanimously affirmed Adams's conviction. At that level, Adams argued only with respect to the seizure of the personal papers,[27] repeating his state and federal constitutional objections. Although New York's court of last resort had brusquely disposed of the federal constitutional objections by stating that "Articles Fourth and Fifth of the amendments to the Constitution of the United States do not apply to actions in the state courts,"[28] the Supreme Court reached out to discuss the merits of Adams's arguments, assuming (while explicitly not deciding) that the federal provisions did apply.[29] Having eschewed deciding whether the Fourth and Fifth Amendments even applied to a state criminal prosecution, the Court opined that neither had been violated on the facts of the case: "An examination of this record convinces us that there has been no violation of these constitutional restrictions, either in an unreasonable search or seizure, or in compelling the plaintiff in error to testify against himself."[30]

Of far greater importance than the result in *Adams* was the Court's explanation of why it found no Fourth Amendment violation. At trial, Adams had objected to the introduction of police testimony regarding Adams's private papers. The Court took a position that, after its own decision in *Boyd*, seems surprising. Referring to Adams's argument, the Court observed:

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26. The prosecution produced no warrant at the trial, and the trial court declined to permit the defendant to introduce evidence to show that there had been no warrant. *See id.* at 640.

27. The opinion of New York's intermediate appellate court is not a beacon of clarity, but it suggests that the defendant's original objection was both to the seizure of the gambling materials and to the non-gambling material that the defendant was clearly entitled to possess. *See* People v. Adams, 83 N.Y.S. 481, 485-86 (App. Div. 1903), *aff'd*, 68 N.E. 636 (N.Y. 1903), *aff'd*, 192 U.S. 585 (1904).

28. *Adams*, 68 N.E. at 638.

29.

> We do not feel called upon to discuss the contention that the 14th Amendment has made the provisions of the Fourth and Fifth Amendments to the Constitution of the United States, so far as they relate to the right of the people to be secure against unreasonable searches and seizures and protect them against being compelled to testify in a criminal case against themselves, privileges and immunities of citizens of the United States of which they may not be deprived by the action of the states.

*Adams*, 192 U.S. at 594. Justice Brandeis would probably have been appalled to see the Court declining to decide a constitutional issue that it really did have to reach in favor of deciding two constitutional issues that it might not have had to reach. *See* Ashwander v. Tenn. Valley Auth., 297 U.S. 288, 346-48 (1936) (Brandeis, J., concurring) (cautioning against unnecessary decision of constitutional questions when other grounds for decision are available).

30. *Adams*, 192 U.S. at 594.

> The question was not made in the attempt to resist an unlawful seizure of the private papers of the plaintiff in error, but arose upon objection to the introduction of testimony clearly competent as tending to establish the guilt of the accused of the offense charged. In such cases the weight of authority as well as reason limits the inquiry to the competency of the proffered testimony, and the courts do not stop to inquire as to the means by which the evidence was obtained.[31]

That declaration, of course, required the Court to do something about *Boyd*. It distinguished *Boyd* by observing that the statute involved in that case required the defendant to participate actively in his own conviction, but that a search warrant, requiring no action on the part of the defendant, was a different creature for constitutional purposes.[32]

Perhaps because of *Adams*, the Court itself and constitutional scholars identify *Weeks v. United States*[33] rather than *Boyd* as the source of the rule that evidence seized in violation of the Fourth Amendment must be excluded from the defendant's trial.[34] Missouri police officers arrested Weeks in a public place.[35] At approximately the same time, other officers entered Weeks's home without a warrant (using a key that a neighbor pointed out) and took away some of his papers and other articles. These they delivered to the U.S. Marshal, with whom they returned later that day. The marshal searched the suspect's home (also without a warrant) and found additional papers. The government charged Weeks

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31. *Id.*

32.

> In *Boyd's Case* the law held unconstitutional, virtually compelled the defendant to furnish testimony against himself in a suit to forfeit his estate, and ran counter to both the 4th and 5th Amendments. The right to issue a search warrant to discover stolen property or the means of committing crimes is too long established to require discussion. The right of seizure of lottery tickets and gambling devices, such as policy slips, under such warrants, requires no argument to sustain it at this day. But the contention is that, if in the search for the instruments of crime, other papers are taken, the same may not be given in evidence. As an illustration—if a search warrant is issued for stolen property, and burglars' tools be discovered and seized, they are to be excluded from testimony by force of these amendments. We think they were never intended to have that effect, but are rather designed to protect against compulsory testimony from a defendant against himself in a criminal trial, and to punish wrongful invasion of the home of the citizen or the unwarranted seizure of his papers and property, and to render invalid legislation or judicial procedure having such effect.

*Id.* at 598.

33. 232 U.S. 383 (1914).

34. *See, e.g.*, Wolf v. Colorado, 338 U.S. 25, 28 (1949) (stating that "[i]n *Weeks v. United States* . . . this Court held that in a federal prosecution the Fourth Amendment barred the use of evidence secured through an illegal search and seizure" and that "[t]his ruling was made for the first time in 1914"); *see also* LAFAVE ET AL., *supra* note 2, § 3.1, at 106.

35. *Weeks*, 232 U.S. at 386.

with unlawful use of the mails. Weeks petitioned for the return of the seized items before trial. The trial court awarded him a truly empty victory, directing return of all items seized that were not pertinent to the charges.[36] Weeks appealed his ensuing conviction to the Supreme Court, setting the stage for the Court to recognize the principle of exclusion:

> If letters and private documents can thus be seized and held and used in evidence against a citizen accused of an offense, the protection of the 4th Amendment, declaring his right to be secure against such searches and seizures, is of no value, and, so far as those thus placed are concerned, might as well be stricken from the Constitution.
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> . . . .
>
> We therefore reach the conclusion that the letters in question were taken from the house of the accused by an official of the United States, acting under color of his office, in direct violation of the constitutional rights of the defendant; that having made a seasonable application for their return, which was heard and passed upon by the court, there was involved in the order refusing the application a denial of the constitutional rights of the accused, and that the court should have restored these letters to the accused. In holding them and permitting their use upon the trial, we think prejudicial error was committed.[37]

*Weeks* stands for the principle that a criminal defendant may demand return of personal property unconstitutionally seized before trial, thus depriving the government of its use as evidence. The Court did not say directly that evidence thus seized was inadmissible as a matter of evidence law, and *Weeks* did not involve a situation where the defendant had no right to possess the items seized, as is the case with contraband. Justice Day's opinion did, however, focus on the impropriety of the courts receiving what the Court regarded as functionally stolen property.

> The effect of the 4th Amendment is to put *the courts of the United States* . . . under limitations and restraints as to the exercise of such power . . . . The tendency of those who execute the criminal laws . . . to obtain conviction by means of unlawful seizures . . . should find no sanction in the judgments of the courts, which are charged at all times with the support of the Constitution . . . .
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> . . . .
>
> To sanction such proceedings would be to affirm by judicial decision a manifest neglect, if not an open defiance, of the prohibitions of the Constitution, intended for the protection of the people against such unauthorized action.[38]

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36. *See id.* at 388.

37. *Id.* at 393, 398.

38. *Id.* at 391-92, 394 (emphasis added).

In *Agnello v. United States*,[39] the Court extended the *Weeks* rationale to require exclusion in the federal courts of all evidence, whether or not the defendant had a right to possess it, that the government seized from a defendant in violation of the Fourth Amendment.[40]

*Silverthorne Lumber Co. v. United States*[41] appeared to confirm that *Weeks* rested in part on the constitutional impropriety of the courts receiving evidence seized in violation of the Fourth Amendment, and it extended *Weeks*'s prohibition to evidence derived from materials unlawfully seized,[42] thus anticipating the fruit-of-the-poisonous tree doctrine now most commonly associated with *Wong Sun v. United States*.[43] The government indicted the corporate and individual defendants and, while the individuals were in custody, conducted an illegal search of the company office, seizing numerous books and papers. The government then photographed the illegally seized items. Upon the defendants' motion, the district court ordered return of the originals but retained the photographs. The government then secured a new indictment on the basis of the photographed documents and subpoenaed the originals from the defendants. A unanimous Court reacted indignantly,[44] refusing to permit the government to benefit in any way from unconstitutional actions, a position of purity now many times rejected by more modern Courts, which permit use of unlawfully acquired evidence for impeachment and other purposes.[45]

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39. 269 U.S. 20 (1925) (suppression of illegal drugs).

40. *Id.* at 32. This followed the lead of several lower federal courts that had suppressed illegally seized evidence on the authority of *Weeks*. *See, e.g.*, United States v. Legman, 295 F. 474 (3d Cir. 1924) (suppressing unlawfully possessed liquor); United States v. Myers, 287 F. 260 (W.D. Ky. 1923) (same); United States v. Case, 286 F. 627 (D.S.D. 1923) (holding that evidence from a search jointly conducted by state and federal law enforcement officers was inadmissible in federal court because only the state officer had a warrant); United States v. Bush, 269 F. 455 (W.D.N.Y. 1920) (suppressing stolen underwear).

41. 251 U.S. 385 (1920).

42. *Id.* at 392.

43. 371 U.S. 471 (1963).

44. *Silverthorne*, 251 U.S. at 391-92 (citations omitted):

> The proposition could not be presented more nakedly. It is that although of course its seizure was an outrage which the Government now regrets, it may study the papers before it returns them, copy them, and then may use the knowledge that it has gained to call upon the owners in a more regular form to produce them; that the protection of the Constitution covers the physical possession but not any advantages that the Government can gain over the object of its pursuit by doing the forbidden act. . . . In our opinion such is not the law. It reduces the Fourth Amendment to a form of words. The essence of a provision forbidding the acquisition of evidence in a certain way is that not merely evidence so acquired shall not be used before the Court but that it shall not be used at all.

45. The modern Court has considerably diluted *Silverthorne*'s lesson. The government may now use unconstitutionally acquired evidence in a number of ways. *See, e.g.*, United States v.

The ringing words of *Boyd*, *Weeks*, and *Silverthorne* may have implied a degree of Fourth Amendment protection that did not really exist. Soon after those cases, the Court began to discover limits on the Amendment's protection. For one thing, the Amendment did not apply to the states at all,[46] a position the Court maintained until *Wolf v. Colorado*[47] in 1949. Although *Wolf* ruled that the Fourteenth Amendment's Due Process Clause incorporated the protections of the Fourth Amendment, it refused to apply the exclusionary rule to the states.[48] That did not happen until 1961.[49] For another, the Court conceptualized the

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Leon, 468 U.S. 897 (1984) (admitting evidence seized in good faith reliance on an invalid search warrant); Nix v. Williams, 467 U.S. 431 (1984) (holding that evidence found as a result of questioning defendant in violation of his right to counsel should be admitted on a theory that the police would inevitably have discovered the evidence); United States v. Havens, 446 U.S. 620 (1980) (forbidding use of illegally obtained evidence to impeach defendant's testimony on elements of crime charged); Oregon v. Hass, 420 U.S. 714 (1975) (holding that statements taken from defendant when questioning continued, in violation of *Miranda v. Arizona*, 384 U.S. 436 (1966), after defendant requested an attorney could be used to impeach); Harris v. New York, 401 U.S. 222 (1971) (holding that statements taken from defendant in custody but not given warnings required by *Miranda* could be used to impeach); Walder v. United States, 347 U.S. 62 (1954) (allowing use of illegally obtained evidence to impeach defendant's testimony on matters going beyond elements of crime charged). *But see* James v. Illinois, 493 U.S. 307 (1990) (holding that illegally obtained evidence not admissible to impeach non-defendant witness).

46. *See* Smith v. Maryland, 59 U.S. (18 How.) 71 (1855); United States v. Case, 286 F. 627, 628 (D.S.D. 1923) ("There is no doubt but that . . . articles 4 and 5 of the Amendments to the Constitution of the United States do not apply to actions in the state courts."). One may regard these cases merely as specific applications of the general rule that Chief Justice Marshall announced in *Barron v. Mayor and City Council of Baltimore*, 32 U.S. (7 Pet.) 243 (1833), to the effect that the Bill of Rights as a whole did not apply to the states.

47. 338 U.S. 25 (1949).

48. The *Wolf* Court held "that in a prosecution in a State court for a State crime the Fourteenth Amendment does not forbid the admission of evidence obtained by an unreasonable search and seizure." *Id.* at 33.

49. *See* Mapp v. Ohio, 367 U.S. 643 (1961). In the mid-1980s, the Court specifically rejected applying the exclusionary rule to the states, using instead a due-process, shock-the-conscience test from the Fourteenth Amendment first articulated in *Rochin v. California*, 342 U.S. 165 (1952). *See* Irvine v. California, 347 U.S. 128, 134 (1954) (plurality opinion):

> Never until June of 1949 did this Court hold the basic search-and-seizure prohibition in any way applicable to the states under the Fourteenth Amendment. At that time, as we pointed out, thirty-one states were not following the federal rule excluding illegally obtained evidence, while sixteen were in agreement with it. Now that the Wolf doctrine is known to them, state courts may wish further to reconsider their evidentiary rules. But to upset state convictions even before the states have had adequate opportunity to adopt or reject the rule would be an unwarranted use of federal power. The chief burden of administering criminal justice rests upon state courts. To impose upon them the hazard of federal reversal for noncompliance with standards as to which this Court and its members have been so inconstant and inconsistent would not be justified. We adhere

Amendment's protections strictly in terms of property concepts of trespass, a limitation that became more significant over time with the advent of widespread electronic communication and the development of methods for intercepting such communication without trespass. Finally, the Court was slow to come to the position that intangibles—specifically conversations—could be the subject of a Fourth Amendment seizure at all.

*Olmstead v. United States*[50] involved a prosecution for conspiracy to violate prohibition. The government obtained evidence against the defendants by wiretapping their telephones and recording the conversations. As the Court noted, the government gathered information for many months, and it revealed a sizable, ongoing conspiracy.[51] The majority recited *Boyd*, *Weeks*, and *Silverthorne*, but distinguished them on two bases. First, the Court noted that

> [t]he amendment itself shows that the search is to be of material things—the person, the house, his papers, or his effects. The description of the warrant necessary to make the proceeding lawful is that it must specify the place to be searched and the person or *things* to be seized.[52]

Second, the Court focused on trespass, finding none because there had been no entry of the defendants' space.[53] This was dispositive; the Fourth Amendment simply did not reach the government's activity.[54] Part of the defendants' argument relied on wiretapping being a misdemeanor under state law, but the majority declined to recognize that as a basis for exclusion, arguing that at common law evidence was admissible no matter how obtained and characterizing *Weeks* as an exception to the common law, applicable only when the means of procurement of the evidence violated the Fourth or Fifth Amendments.[55] Moreover, the Court pointed out that the state statute itself did not make seized evidence inadmissible.[56] These two prongs of the *Olmstead* approach—whether words could be the subject of a Fourth Amendment search or seizure and whether the government had acquired its evidence by means of spatial intrusion—remained staples of the Court's analysis for decades.

Justice Brandeis dissented in what became a classic statement of why the Constitution should hold the government to the highest standards of behavior. He excoriated the government's tactics, giving the prosecution credit only for being candid about their use and offensiveness.[57] He noted that the Court, following

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to Wolf as stating the law of search-and-seizure cases and decline to introduce vague and subjective distinctions.

50. 277 U.S. 438 (1928).

51. *Id.* at 457.

52. *Id.* at 464.

53. *Id.* at 466.

54. *Id.* at 464-66.

55. *Id.* at 467.

56. *Id.* at 469.

57. The government makes no attempt to defend the methods employed by its officers.

Chief Justice John Marshall's admonition that "'[w]e must never forget . . . that it is a constitution we are expounding,'"[58] had interpreted congressional power specifically and government power generally under the Constitution with an eye toward changed conditions in the 140 years since ratification.[59] In light of that, Justice Brandeis urged that constitutional provisions guaranteeing individual rights were entitled to the same sort of interpretation because science and technology had changed the ways in which government could effect the kinds of intrusions against which the Fourth and Fifth Amendments cautioned.[60] He recalled the spirit of *Boyd*, chastising the majority Justices for having forgotten its teaching. He finished with what has become one of the most famous paragraphs in any Supreme Court opinion.

> Decency, security and liberty alike demand that government officials shall be subjected to the same rules of conduct that are commands to the citizen. In a government of laws, existence of the government will be imperiled if it fails to observe the law scrupulously. Our Government is the potent, the omnipresent teacher. For good or for ill, it teaches the whole people by its example. Crime is contagious. If the Government becomes a lawbreaker, it breeds contempt for law; it invites every man to become a law unto himself; it invites anarchy. To declare that in the administration of the criminal law the end justifies the means—to declare that the Government may commit crimes in order to secure the conviction of a private criminal—would bring terrible retribution. Against that pernicious doctrine this Court should resolutely set its face.[61]

Despite Justice Brandeis's inspiring words, his view was a dissent. Justices Holmes, Butler, and Stone also dissented, but the day went to the view that trespass was required for a Fourth Amendment violation and that words were not subject to Fourth Amendment protection.

*Goldman v. United States*[62] followed the rationale of *Olmstead*. *Goldman* did not involve a wiretap, but rather a speech detection device placed against a wall for the purpose of hearing conversations on the far side of the wall. The Court ruled that this could not be a Fourth Amendment violation because there was no

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> Indeed, it concedes that, if wire-tapping can be deemed a search and seizure within the Fourth Amendment, such wire-tapping as was practiced in the case at bar was an unreasonable search and seizure, and that the evidence thus obtained was inadmissible. But it relies on the language of the amendment; and it claims that the protection given thereby cannot properly be held to include a telephone conversation.

*Id.* at 471-72 (Brandeis, J., dissenting).

58. *Id.* at 472 (quoting McCulloch v. Maryland, 17 U.S. (4 Wheat.) 316 (1819)).

59. *Id.* (citations omitted).

60. Justice Brandeis stated that "[c]lauses guaranteeing to the individual protection against specific abuses of power, must have a similar capacity of adaptation to a changing world." *Id.*

61. *Id.* at 485.

62. 316 U.S. 129 (1942).

trespass.[63] Similarly, in one of the false-friend cases, the Justices again relied on the absence of trespass as their rationale for receiving evidence of a surreptitiously recorded conversation between the defendant and a government agent.[64]

*Olmstead* did not reign entirely unchallenged, however. Shortly afterward, Congress sharply limited interception and disclosure of telephone conversations.[65] The Supreme Court subsequently ruled wiretap evidence inadmissible in federal prosecutions, basing its decision on the congressional prohibition.[66] Thus, the *Olmstead* Court refused suppression although a state statute made it a misdemeanor to engage in the interception that underlay the prosecution, but when Congress adopted the same sort of approach, it made all the difference.

*Olmstead* officially remained the law for thirty-nine years, but its grip began to weaken in 1961. *Silverman v. United States*[67] involved the admissibility of conversations the government had overheard by means of a microphone driven into the wall of the house adjoining Silverman's until it made contact with the heating duct of his house. The duct acted as a sounding board, allowing the police to hear conversations within the defendant's house. Although the Court explicitly declined to reconsider precedent in the area,[68] it did vacate the conviction because the police had trespassed in the defendant's house when their microphone entered his wall and made contact with the heating duct.[69] Although

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63. *Id.* at 134-35.

64. *See* On Lee v. United States, 343 U.S. 747 (1952); *see also infra* notes 125-38 and accompanying text. The Court confirmed its general reliance on trespass theory in *Lopez v. United States*, 373 U.S. 427, 438-39 (1963). *See infra* notes 70-71 and accompanying text.

65. Communications Act of 1934, 47 U.S.C. § 605 (2000); *see also* Berger v. New York, 388 U.S. 41, 51 (1967).

66. *See* Nardone v. United States, 302 U.S. 379 (1937). After the retrial that the Supreme Court's decision necessitated, the case again reached the Justices, with the issue this time being whether the exclusion principle enunciated two years earlier also required exclusion of the "fruits," as set forth in *Wong Sun v. United States*, 371 U.S. 471 (1963), of the wiretaps. The Court confirmed that it did. *See Nardone*, 308 U.S. at 340.

67. 365 U.S. 505 (1961).

68. "Nor do the circumstances here make necessary a re-examination of the Court's previous decisions in the area." *Id.* at 509.

69. The Court did point out that the intrusion necessary to bring the Fourth Amendment into play was not necessarily the same as would support a property action. "[W]e need not pause to consider whether or not there was a technical trespass under the local property law relating to party walls. Inherent Fourth Amendment rights are not inevitably measurable in terms of ancient niceties of tort or real property law." *Id.* at 511 (footnote omitted). *Silverman* may thus represent the Court's first tentative steps away from using property theory as a Fourth Amendment lens. It did, however, still rely quite clearly on the idea of physical intrusion.

> But decision here does not turn upon the technicality of a trespass upon a party wall as a matter of local law. It is based on the reality of an actual intrusion into a constitutionally protected area. . . . We find no occasion to re-examine *Goldman* [where there was no physical intrusion] here, but we decline to go beyond it, by even a fraction

the Court's opinion dealt explicitly with whether or not there had been an intrusion, it may be more significant for its silence about whether the Fourth Amendment protects words. The Court simply assumed that Fourth Amendment analysis was appropriate, an assumption manifestly inconsistent with *Olmstead*.[70]

In *Lopez v. United States*,[71] the defendant sought to exclude from evidence a recording of a conversation he had with an undercover federal agent after inviting the undercover agent into the defendant's office. The Court ruled the evidence admissible (an unsurprising result under *Olmstead*), but it did so *after* Fourth Amendment analysis.[72] Strict application of *Olmstead* would have eschewed such analysis on the ground that conversations were not among the items to which the Fourth Amendment could apply. Although *Lopez* did not explicitly overrule the first part of *Olmstead*, it was clear that the ground under *Olmstead* had become unstable because of both *Silverman* and *Lopez*.[73]

*Berger v. New York*[74] apparently completed the erosion of this branch of the *Olmstead* approach. A New York statute conditionally authorized law enforcement wiretapping. The Court found the statute unconstitutional under the Fourth Amendment because it failed to require particularity consonant with the Amendment.[75] *Berger* did not explicitly overrule *Olmstead*, but Justice Douglas's concurring opinion, in a statement not challenged by the opinion for the Court, confirmed that it effectively had: "I join the opinion of the Court because at long last it overrules *sub silentio Olmstead v. United States* and its offspring and brings wiretapping and other electronic eavesdropping fully within the purview of the

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of an inch.

*Id.* at 512 (citation omitted).

70. In *Hoffa v. United States*, 385 U.S. 293, 301 (1966) (citing *Silverman*, 365 U.S. 505), the Court credited *Silverman* with establishing that words were subject to seizure for Fourth Amendment purposes: "And the protections of the Fourth Amendment are surely not limited to tangibles, but can extend as well to oral statements."

Justice Harlan, on the other hand, appeared to regard *Wong Sun*, 371 U.S. 471, as the source of that particular change, referring to it as having "expressly brought verbal communication within the sweep of the Fourth Amendment . . . ." United States v. White, 401 U.S. 745, 775 (1971) (Harlan, J., dissenting). That may be a bit of an overstatement. *Wong Sun* held only that statements overheard as a result of an unlawful invasion are suppressible as fruits of a Fourth Amendment violation. Although the Court's opinion did make the statement that "[i]t follows from our holding in *Silverman* . . . that the Fourth Amendment may protect against the overhearing of verbal statements . . . ," *Wong Sun*, 371 U.S. at 485, the statement was dictum and, in any case, relied expressly on *Silverman*.

71. 373 U.S. 427 (1963).

72. *Id.* at 440.

73. *See also* Osborn v. United States, 385 U.S. 323 (1966) (permitting introduction of a surreptitiously made recording, but only after finding that the procedures authorizing the recording in the case satisfied the requirements of the Fourth Amendment).

74. 388 U.S. 41 (1967).

75. *Id.* at 58-59.

Fourth Amendment."[76]

The second *Olmstead* rule—that no Fourth Amendment violation could occur without a trespass—fell later the same year. *Katz v. United States*[77] involved wiretapping the telephone in a public booth from which the government suspected Katz was placing bets in violation of federal law. The Court announced a substantial shift in the way it would analyze Fourth Amendment cases. Katz had phrased the issues presented with respect to "constitutionally protected areas," asking both whether a public telephone booth was such a place and whether physical trespass was a precondition to invoking Fourth Amendment rights,[78] but the Court "decline[d] to adopt this formulation of the issues,"[79] subsequently referring to "the misleading way the issues have been formulated."[80] It criticized Katz's reliance on the idea of constitutionally protected areas and his inferred equation of the Fourth Amendment with some sort of constitutional right to privacy.[81] In a ringing declaration destined to be just as misleading as the Court-inspired phrase "constitutionally protected areas," the Court asserted:

> For the Fourth Amendment protects people, not places. What a person knowingly exposes to the public, even in his own home or office, is not a subject of Fourth Amendment protection. But what he seeks to preserve as private, even in an area accessible to the public, may be constitutionally protected.[82]

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76. *Id.* at 64 (Douglas, J., concurring); *see also id.* at 78-79 (Black, J., dissenting) (reiterating the *Olmstead* rationale while clearly recognizing that the Court had abandoned it).

77. 389 U.S. 347 (1967).

78. Justice Stewart's majority opinion quoted *Katz*'s formulations:

> A. Whether a public telephone booth is a constitutionally protected area so that evidence obtained by attaching an electronic listening recording device to the top of such a booth is obtained in violation of the right to privacy of the user of the booth.
>
> B. Whether physical penetration of a constitutionally protected area is necessary before a search and seizure can be said to be violative of the Fourth Amendment to the United States Constitution.

*Id.* at 349-50 (internal quotation marks omitted).

79. *Id.* at 350.

80. *Id.* at 351. Justice Stewart was gracious enough to acknowledge that the Court might bear some of the responsibility: "It is true that this Court has occasionally described its conclusions in terms of 'constitutionally protected areas,' . . . ." He cited the Court's very recent opinions in *Silverman v. United States*, 365 U.S. 505 (1961); *Lopez v. United States*, 373 U.S. 427 (1963); and *Berger*, 388 U.S. 41, though he recovered later in the same sentence to attach the blame to *Katz*: "but we have never suggested that this concept can serve as a talismanic solution to every Fourth Amendment problem." *Katz*, 389 U.S. at 351 n.9.

81. *Katz*, 389 U.S. at 350.

82. *Id.* at 351-52 (citations omitted). For a discussion of how the Court's subsequent Fourth Amendment jurisprudence may support the conclusion that the Amendment continues to protect places, not people, see Donald L. Doernberg, *"The Right of the People": Reconciling Collective and Individual Interests Under the Fourth Amendment*, 58 N.Y.U. L. REV. 259, 267-71 (1983). Query whether Justice Stewart would have equated "exposes to the world" with "reveals to

That is all well and good, but as is so often the case, the Court was long on rhetoric but short on specifics of how the new approach would apply.[83] It clearly rejected the government's argument that because Katz made his calls from a place where he could easily be observed, he was entitled to no more privacy than he would have had outside the booth, from where he might have been overheard.

> But what he sought to exclude when he entered the booth was not the intruding eye—it was the uninvited ear. . . . One who occupies [a telephone booth], shuts the door behind him, and pays the toll that permits him to place a call is surely entitled to assume that the words he

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anyone." *See infra* note 121 and accompanying text.

83. It is perhaps a bit unfair to criticize the Court too strongly for this. The Justices are, after all, supposed to decide the case before them without gratuitously elaborating what they might do in future cases. On the other hand, in other constitutional areas the Court has articulated qualitative standards that have been considerably easier to apply to succeeding cases. *See, e.g.*, Schenck v. United States, 249 U.S. 47 (1919) (articulating the clear-and-present-danger test). Although the Court modified the *Schenck* test some decades later, and it continues to evolve, *see* JOHN E. NOWAK & RONALD D. ROTUNDA, CONSTITUTIONAL LAW §§ 16.13, 16.14, 16.15, at 1080-90 (7th ed. 2004), its implementation has not compelled the Court to revisit it often. By contrast, in the thirty-eight years since the decision in *Katz*, the Court has decided more than thirty-five cases that attempt to deal with the standard that *Katz* articulated. *See, e.g.*, Kyllo v. United States, 533 U.S. 27 (2001) (thermal imaging device directed at home); Bond v. United States, 529 U.S. 334 (2000) (physical manipulation of a bus passenger's carry-on bag); Minnesota v. Carter, 525 U.S. 83 (1998) (short-time visitors in apartment for commercial purpose); Minnesota v. Olson, 495 U.S. 91 (1990) (overnight guest in apartment); Florida v. Riley, 488 U.S. 445 (1989) (helicopter overflight of curtilage); New Jersey v. T.L.O., 469 U.S. 325 (1985) (search of public school student's purse); United States v. Knotts, 460 U.S. 276 (1983) (beeper tracking device); Smith v. Maryland, 442 U.S. 735 (1979) (pen register recording telephone numbers called). As Professors LaFave, Israel, and King observed, "[T]he Court substituted for a workable tool that often proved unjust a new test that was difficult to apply." LAFAVE ET AL., *supra* note 2, § 3.2, at 128 (footnotes omitted).

The Court has had to revisit the field of personal jurisdiction far less frequently, even though the constitutional limits of personal jurisdiction are hardly beacons of clarity following the Court's groundbreaking decision in *International Shoe Co. v. Washington*, 326 U.S. 310 (1945). *See, e.g.*, Kulko v. Superior Court, 436 U.S. 84, 92 (1978) (acknowledging that the *International Shoe* test rarely yields clear answers by stating that "[t]he greys are dominant and even among them the shades are innumerable"). In the sixty-one years since the Court decided *International Shoe*, it has decided only fourteen cases attempting to elaborate the meaning of "minimum contacts . . . such that the maintenance of the suit does not offend 'traditional notions of fair play and substantial justice.'" *Id.* at 316 (quoting Milliken v. Meyer, 311 U.S. 457, 463 (1940)); *see, e.g.*, Burnham v. Superior Court, 495 U.S. 604 (1990); Asahi Metal Indus. Co. v. Superior Court, 480 U.S. 102 (1987); Burger King Corp. v. Rudzewicz, 471 U.S. 462 (1985); Helicopteros Nacionales de Colombia, S.A. v. Hall, 466 U.S. 408 (1984); Worldwide Volkswagen Corp. v. Woodson, 444 U.S. 286 (1980); *Kulko*, 436 U.S. 84; Shaffer v. Heitner, 433 U.S. 186 (1977); Hanson v. Denckla, 357 U.S. 235 (1958); McGee v. Int'l Life Ins. Co., 355 U.S. 220 (1957); Perkins v. Benguet Consolidated Mining Co., 342 U.S. 437 (1952).

utters into the mouthpiece will not be broadcast to the world.[84]

Relying on *Olmstead*, the government argued that there could be no Fourth Amendment violation without physical intrusion into the telephone booth. Criticizing the "narrow view" underlying *Olmstead*, Justice Stewart's majority opinion noted that *Silverman v. United States*[85] had effectively overruled *Olmstead*'s view that intangibles could not be the subject of a Fourth Amendment seizure.[86] Linking that change with the Court's new idea that the Fourth Amendment was concerned with people rather than areas, he interred *Olmstead*'s remaining holding.[87]

Justice Harlan concurred, but he questioned the utility of the majority's people-not-places formulation.[88] In the process, he articulated a two-part standard that has come to be more important than the majority's opinion.[89]

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84. *Katz*, 389 U.S. at 352. And yet, the Court's application of the expectation-of-privacy analysis developed from Justice Harlan's concurring opinion in *Katz* compels the individual to assume the very opposite. *See infra* notes 125-221 and accompanying text.

85. 365 U.S. 505 (1961).

86. *Katz*, 389 U.S. at 353.

87.

> We conclude that the underpinnings of *Olmstead* and *Goldman* have been so eroded by our subsequent decisions that the "trespass" doctrine there enunciated can no longer be regarded as controlling. The Government's activities in electronically listening to and recording the petitioner's words violated the privacy upon which he justifiably relied while using the telephone booth and thus constituted a "search and seizure" within the meaning of the Fourth Amendment. The fact that the electronic device employed to achieve that end did not happen to penetrate the wall of the booth can have no constitutional significance.

*Id.*

88. *Id.* at 361.

89. *See, e.g.*, Minnesota v. Carter, 525 U.S. 83, 97 (1998) (Scalia, J., concurring) (characterizing Katz as having "come to mean the test enunciated by Justice Harlan's separate concurrence"). Justice Scalia also criticized the test as "self-indulgent" and mocked its continued use:

> In my view, the only thing the past three decades have established about the *Katz* test . . . is that, unsurprisingly, those "actual (subjective) expectation[s] of privacy" "that society is prepared to recognize as 'reasonable,'" bear an uncanny resemblance to those expectations of privacy that this Court considers reasonable. When that self-indulgent test is employed (as the dissent would employ it here) to determine whether a "search or seizure" within the meaning of the Constitution has *occurred* (as opposed to whether that "search or seizure" is an "unreasonable" one), it has no plausible foundation in the text of the Fourth Amendment. That provision did not guarantee some generalized "right of privacy" and leave it to this Court to determine which particular manifestations of the value of privacy "society is prepared to recognize as 'reasonable.'" Rather, it enumerated ("persons, houses, papers, and effects") the objects of privacy protection to which the *Constitution* would extend, leaving further expansion to the good

> As the Court's opinion states, "the Fourth Amendment protects people, not places." The question, however, is what protection it affords to those people. Generally, as here, the answer to that question requires reference to a "place." My understanding of the rule that has emerged from prior decisions is that there is a twofold requirement, first that a person have exhibited an actual (subjective) expectation of privacy and, second, that the expectation be one that society is prepared to recognize as "reasonable." Thus a man's home is, for most purposes, a place where he expects privacy, but objects, activities, or statements that he exposes to the "plain view" of outsiders are not "protected" because no intention to keep them to himself has been exhibited. On the other hand, conversations in the open would not be protected against being overheard, for the expectation of privacy under the circumstances would be unreasonable.[90]

The Court has subsequently focused on both components of Justice Harlan's view. Not surprisingly, determining when a subjective expectation of privacy is reasonable for Fourth Amendment purposes has occasioned the most dispute.

*Katz* expanded the realm of Fourth Amendment protection,[91] shifting the focus of the inquiry from trespass to privacy. Over the last three decades, however, Justice Harlan's approach has been used more often to deny Fourth Amendment protection than to confirm it, despite the probable existence of a subjective expectation of privacy. For example, *Rakas v. Illinois*[92] held that a passenger in a vehicle has no reasonable expectation of privacy with respect to

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> judgment, not of this Court, but of the people through their representatives in the legislature.

*Id.* at 97-98 (Scalia, J., concurring) (citations omitted); *see also* Maryland v. Garrison, 480 U.S. 79, 90-91 (1987) (Blackmun, J., dissenting) ("As articulated by Justice Harlan in his *Katz* concurrence, the proper test under the Amendment is 'whether a person [has] exhibited an actual (subjective) expectation of privacy . . . that society is prepared to recognize as "reasonable."'" (alteration in original)). Justice Harlan's approach actually gained majority status only a year after Katz. Justice Harlan's opinion in *Mancusi v. DeForte*, 392 U.S. 364 (1968), noted that "*Katz* . . . also makes it clear that capacity to claim the protection of the Amendment depends not upon a property right in the invaded place but upon whether the area was one in which there was a reasonable expectation of freedom from governmental intrusion." *Id.* at 392 (citation omitted).

90. *Katz*, 389 U.S. at 361 (Harlan, J., concurring). Justice Harlan was characteristically accurate in his assessment of the Court's people-not-places formulation. The Court has been unable to deal with the concept of privacy separate from the location involved. *See, e.g.*, Kyllo v. United States, 533 U.S. 27 (2001) (finding use of an external heat-detecting sensor to determine whether there was an unusual heat source in the defendant's home violated the Fourth Amendment).

91. *See, e.g.*, Brian J. Serr, *Great Expectations of Privacy: A New Model for Fourth Amendment Protection*, 73 MINN. L. REV. 583, 606 (1989) (seeing *Katz* as expanding the protection offered by the Amendment).

92. 439 U.S. 128 (1978).

the vehicle,[93] and *Rawlings v. Kentucky*[94] announced that one who has placed something in another's closed purse for safekeeping with the owner's consent nonetheless has no reasonable expectation of privacy.[95] Similarly, one has no reasonable expectation of privacy in an apartment, even as an invitee, unless one at least spends the night.[96] All told, the Court has used Justice Harlan's reasonable-expectation-of-privacy approach at least fifteen times to deny Fourth Amendment protection[97] and only six times to grant it.[98]

The average person might be surprised to discover the limits the Supreme Court has imposed upon expectations "that society is prepared to recognize as 'reasonable.'"[99] The Court has ruled, for example, that there is no reasonable expectation of privacy in the telephone numbers that one dials, which means that there is no Fourth Amendment impediment to the government finding out and keeping track of all of the telephone numbers that one calls.[100] The Court's rationale is that telephone subscribers have voluntarily revealed the numbers they call to the telephone company for connection and billing purposes.[101] "[I]t is too much to believe that telephone subscribers, under these circumstances, harbor any general expectation that the numbers they dial will remain secret."[102]

Justices Stewart, Marshall, and Brennan took issue with that approach. Justice Stewart's dissent noted that although most people list their home numbers

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93. *Id.* at 148-49.

94. 448 U.S. 98 (1980).

95. *Id.* at 104-05.

96. *Compare* Minnesota v. Carter, 525 U.S. 83 (1998) (holding persons in apartment for purposes of packaging cocaine for sale have no reasonable expectation of privacy), *with* Minnesota v. Olson, 495 U.S. 91 (1990) (holding that an overnight guest does have a reasonable expectation of privacy). The Court has not elaborated whether an overnight guest in the apartment for purposes of packaging cocaine for sale has such an expectation. The lesson of *Carter* and *Olson* may be that in order to secure Fourth Amendment rights when in another's house, the first thing to do is go to sleep.

97. *See Carter*, 525 U.S. 83; Florida v. Riley, 488 U.S. 445 (1989); California v. Greenwood, 486 U.S. 35 (1988); New York v. Burger, 482 U.S. 691 (1987); United States v. Dunn, 480 U.S. 294 (1987); California v. Ciraolo, 476 U.S. 207 (1986); Dow Chem. v. United States, 476 U.S. 227 (1986); United States v. Karo, 468 U.S. 705 (1984); Hudson v. Palmer, 468 U.S. 517 (1984); Oliver v. United States, 466 U.S. 170 (1984); United States v. Knotts, 460 U.S. 276 (1983); *Rawlings*, 448 U.S. 98; Smith v. Maryland, 442 U.S. 735 (1979); *Rakas*, 439 U.S. 128; United States v. White, 401 U.S. 745 (1971).

98. *See* Kyllo v. United States, 533 U.S. 27 (2001); Bond v. United States, 529 U.S. 334 (2000); *Olson*, 495 U.S. 91; Winston v. Lee, 470 U.S. 753 (1985); Arkansas v. Sanders, 442 U.S. 753 (1979), *abrogated by* California v. Acevedo, 500 U.S. 565 (1991); United States v. Chadwick, 433 U.S. 1 (1977), *abrogated by* California v. Acevedo, 500 U.S. 565 (1991).

99. Katz v. United States, 389 U.S. 347, 361 (1967) (Harlan, J., concurring).

100. *See Smith*, 442 U.S. 735 (using pen register to record numbers called invades no privacy interest of caller).

101. *Id.* at 743.

102. *Id.*

in telephone directories, he doubted that they would so sanguinely make public the list of people whom they call. "This is not because such a list might in some sense be incriminating, but because it easily could reveal the identities of the persons and the places called, and thus reveal the most intimate details of a person's life."[103]

Justice Marshall pointed out a sharp and significant difference between his and the majority's approach to the concept of privacy under the Fourth Amendment.

> [E]ven assuming . . . that individuals "typically know" that a phone company monitors calls for internal reasons, it does not follow that they expect this information to be made available to the public in general or the government in particular. *Privacy is not a discrete commodity, possessed absolutely or not at all.* Those who disclose certain facts to a bank or phone company for a limited business purpose need not assume that this information will be released to other persons for other purposes.[104]

The majority had indeed taken an all-or-nothing approach to privacy, although without highlighting it. To the majority, information about the numbers that subscribers called was either secret or not.[105] Justice Blackmun acknowledged no concept of release of information to a limited audience and for a limited purpose. Justice Marshall, on the other hand, recognized a relative expectation of privacy—the idea that one may sacrifice absolute privacy without sacrificing all privacy. The dispute over the meaning of *Katz*'s expectation-of-privacy formulation is central to the Court's approach to the false-friend cases discussed below.[106] Justice Marshall also rejected the majority's assumption-of-risk analysis with respect to communications, unwilling to accept the idea that whenever one communicates with someone else he must assume that the government may get the conversation's contents.[107] He warned, in terms that seem particularly prescient today, of the price to be paid for the Court's dismissal of constitutional privacy concerns.

> The prospect of unregulated governmental monitoring will undoubtedly prove disturbing even to those with nothing illicit to hide. Many individuals, including members of unpopular political organizations or journalists with confidential sources, may legitimately wish to avoid disclosure of their personal contacts. Permitting governmental access to

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103. *Id.* at 748 (Stewart, J., dissenting).

104. *Id.* at 749 (Marshall, J., dissenting) (emphasis added) (footnote and citation omitted).

105. *See supra* text accompanying note 102.

106. *See infra* notes 125-75 and accompanying text.

107. *Smith*, 442 U.S. at 749 (Marshall, J., dissenting). "In my view, whether privacy expectations are legitimate within the meaning of *Katz* depends not on the risks an individual can be presumed to accept when imparting information to third parties, but on the risks he should be forced to assume in a free and open society." *Id.* at 750.

> telephone records on less than probable cause may thus impede certain forms of political affiliation and journalistic endeavor that are the hallmark of a truly free society.[108]

In light of the recent jailing of a journalist who refused to reveal a confidential source,[109] Justice Marshall's concerns take on an eerie relevance.

It is not just the numbers one calls (which, after all, have no substantive content) that are available to the government. *United States v. Miller*[110] held there is no constitutionally protected privacy interest in bank records maintained by the bank.[111] To the extent that one uses banking services in day-to-day affairs, the government can subpoena all of the records (including canceled checks) that reveal one's financial dealings. The government need make no showing at all, much less a showing of probable cause, to demand production. Consider the amount of individual information that thus may become available to the government: the newspapers and magazines to which she subscribes, the physicians, psychiatrists, and psychologists he visits and how often he visits them, and the political parties and candidates to whom she contributes, to name only a few. Nonetheless, a seven-member majority of the Court ruled that because the records are the bank's, not the individual's, the individual is powerless to prevent access.[112] In the process, the Court explicitly rejected the idea of a relative expectation of privacy, in response to Miller's argument that his bank records contained personal information that he had revealed to the bank for a limited purpose.[113] Instead, it relied on the assumption-of-risk analysis Justice Marshall had criticized in *Smith*.[114]

The Court based its conclusion on the remark in *Katz* that "'[w]hat a person knowingly exposes to the public . . . is not a subject of Fourth Amendment

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108. *Id.* at 751 (citations omitted).

109. *See* Adam Liptak, *A Reporter Jailed: The Overview; Reporter Jailed After Refusing to Name Source*, N.Y. TIMES, July 7, 2005, at A1; Editorial, *Judith Miller Goes to Jail*, N.Y. TIMES, July 7, 2005, at A22. *Time* magazine, on the other hand, decided to turn over its reporter's documents regarding confidential sources. Adam Liptak, *Time, Inc. to Yield Files on Sources, Relenting to U.S.*, N.Y. TIMES, July 1, 2005, at A1.

110. 425 U.S. 435 (1976).

111. *Id.* at 443.

112. *Id.* at 446. The Court thus relied upon property analysis, despite having ostensibly abandoned property as a Fourth Amendment analytical tool in *Katz*. *See supra* note 87 and accompanying text.

113. *Miller*, 425 U.S. at 442-43.

114. "The depositor takes the risk, in revealing his affairs to another, that the information will be conveyed by that person to the Government." *Id.* at 443. Note that the Court performs a minor sleight-of-hand with its wording because it fails to distinguish between cases in which the third party decides to reveal the hitherto confidential information and those in which the government compels it. The majority apparently felt that it was of no constitutional moment that the information recipient's natural solicitousness for its customer's privacy was overcome by the force of arms that a subpoena represents.

protection.'"[115] One might at least question whether *Katz* meant to establish that revealing information to a single member of the public removes whatever Fourth Amendment protection the information might otherwise have enjoyed. In other words, does exposure to someone mean exposure to everyone for Fourth Amendment purposes?

*Miller* is not the most extreme example of the limits that the Court has imposed on the Fourth Amendment. In *United States v. Payner*,[116] a special agent of the Internal Revenue Service ("IRS") approved a covert operation to obtain bank records.[117] When an officer of an offshore bank visited Miami and left his briefcase in the apartment of his dinner companion while the two of them were at a restaurant, a private investigator acting for the IRS entered the apartment with a key its occupant had given him for the purpose of cooperating with the investigation. He removed the bank officer's briefcase and delivered it to the special agent, who had some 400 documents photocopied. While this was happening, a lookout kept watch on the diners, notifying the private investigator when they left the restaurant so that he could replace the briefcase undiscovered. Based on the photocopied documents, the government subpoenaed documents from a Florida bank, and those documents tended to prove that the defendant had filed a false income tax return. Payner moved to suppress the subpoenaed documents and succeeded—until the case reached the Supreme Court. The majority reversed and ordered reinstatement of the guilty verdict that the district court had reached before considering and granting defendant's motion to suppress.[118]

The District Court found that "'the Government affirmatively counsels its agents that the Fourth Amendment standing limitation permits them to purposefully conduct an unconstitutional search and seizure of one individual in order to obtain evidence against third parties . . . .'"[119] The majority held that this finding did not matter because the government's conduct did not violate any Fourth Amendment right of Payner.[120] The Court relied on *Miller* for the

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115. *Id.* at 442 (quoting Katz v. United States, 389 U.S. 347, 351 (1967)).

116. 447 U.S. 727 (1980).

117. *Id.* at 729-30.

118. *Id.* at 731. Justice Powell, author of the majority opinion in *Payner*, explained the unusual sequence:

> The unusual sequence of rulings was a byproduct of the consolidated hearing conducted by the District Court. The court initially failed to enter judgment on the merits. At the close of the evidence, it simply granted respondent's motion to suppress. After the Court of Appeals for the Sixth Circuit dismissed the Government's appeal for want of jurisdiction, the District Court vacated the order granting the motion to suppress and entered a verdict of guilty. The court then reinstated its suppression order and set aside the verdict.

*Id.* at 729 n.2.

119. *Id.* at 730 (quoting United States v. Payner, 434 F. Supp. 113 (N.D. Ohio 1977), *aff'd*, 590 F.2d 206 (6th Cir. 1979), *rev'd*, 447 U.S. 727 (1980)).

120. In fact, Justice Powell found "that respondent lacks standing under the Fourth

proposition that Payner enjoyed no expectation of privacy in his bank's documents, even though the Government discovered them by acquiescing in clearly unconstitutional and possibly criminal activity.[121]

For good or ill, *Katz*, as Justice Harlan conceptualized it, is the governing standard. Even before *Katz*, however, the Court used something like an expectation-of-privacy approach to allow the introduction of evidence that one might have thought to be constitutionally protected.[122] Since *Katz*, the Court has often used the approach to declare the absence of a reasonable expectation of privacy in circumstances in which a majority of people probably believe that the Fourth Amendment does and should protect them from government prying. In particular, the Court has decided a series of "false friend" cases that do nothing so much as emphasize how risky it may be, in Fourth Amendment terms, to have what is ostensibly a private conversation.

## II. THE FALSE FRIEND CASES

The false-friend cases always involve consensual activity. The government does not itself perform a search over the protest of the suspect. Instead, the suspect reveals information to someone he trusts to keep a confidence, not knowing that the individual has already begun actively cooperating with the police in their investigation.[123] The government connection frustrates the suspect's subjective expectation of privacy. The remaining question, in *Katz* terms, is whether his expectation is "one that society is prepared to recognize as 'reasonable.'"[124]

*On Lee v. United States*[125] was the first in the series. The government had arrested On Lee and charged him with dealing in narcotics. While On Lee was

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Amendment to suppress the documents illegally seized . . . ." *Id.* at 731-32. This is a bit of an odd statement for Justice Powell to have made, given that, as he pointed out, the preceding Term had seen the Court's decision in *Rakas v. Illinois*, 439 U.S. 128 (1978), in which a majority that included Justice Powell had ostensibly discarded the vocabulary of standing and stated that the preferable course was to focus on the merits. *See infra* note 203.

121. The Court also declined to order suppression in the exercise of the courts' supervisory power. *Payner*, 447 U.S. at 733-37. Justice Brennan, joined by Justices Marshall and Blackmun, vigorously dissented. Justice Brennan seemed to think the Government's activity was clearly criminal when he discussed the agent's action: "Casper entered the apartment and *stole* Wolstencroft's briefcase." *Id.* at 740 (Brennan, J., dissenting).

122. *See* On Lee v. United States, 343 U.S. 747 (1952); *see also infra* notes 125-29 and accompanying text.

123. Distinguish this situation from one in which an individual acting privately subsequently decides to share with the government what he has learned. In the text situation, the individual acts as a government agent, and his acts are attributable to the government and subject to constitutional standards. If he acts privately, the Constitution imposes no constraint. *See infra* notes 247-60 and accompanying text.

124. Katz v. United States, 389 U.S. 347, 361 (Harlan, J., concurring) (citations omitted).

125. 343 U.S. 747 (1952).

free on bail, Chin Poy (a former employee of On Lee turned government informer) engaged him in conversation, and On Lee made incriminating statements. Chin Poy was wearing a microphone, which transmitted the conversation to a Narcotics Bureau agent stationed outside On Lee's laundry, where the conversation took place. The agent subsequently testified at On Lee's trial.[126] On Lee objected to the testimony on Fourth Amendment grounds, but the district court allowed the evidence. The jury convicted On Lee of selling a pound of opium and of conspiring to sell opium. The issue of whether Chin Poy's conduct violated the Fourth Amendment came to the Supreme Court, where a five-to-four majority held that there was no Fourth Amendment violation.[127]

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126. The Court originally expressed mystification about why Chin Poy himself did not testify. "For reasons left to our imagination, Chin Poy was not called to testify about petitioner's incriminating admissions." *Id.* at 749. Justice Jackson's imagination seemed equal to the task later in the opinion:

> The normal manner of proof would be to call Chin Poy and have him relate the conversation. We can only speculate on the reasons why Chin Poy was not called. It seems a not unlikely assumption that the very defects of character and blemishes of record which made On Lee trust him with confidences would make a jury distrust his testimony. Chin Poy was close enough to the underworld to serve as bait, near enough the criminal design so that petitioner would embrace him as a confidante, but too close to it for the Government to vouch for him as a witness. Instead, the Government called agent Lee. We should think a jury probably would find the testimony of agent Lee to have more probative value than the word of Chin Poy.

*Id.* at 756.

Perhaps I give Justice Jackson undeserved credit for imagination. A decade later, Chief Justice Warren pointed out other advantages to the government in not calling Chin Poy to testify:

> However, there were further advantages in not using Chin Poy. Had Chin Poy been available for cross-examination, counsel for On Lee could have explored the nature of Chin Poy's friendship with On Lee, the possibility of other unmonitored conversations and appeals to friendship, the possibility of entrapments, police pressure brought to bear to persuade Chin Poy to turn informer, and Chin Poy's own recollection of the contents of the conversation. His testimony might not only have seriously discredited the prosecution, but might also have raised questions of constitutional proportions. This Court has not yet established the limits within which the police may use an informer to appeal to friendship and camaraderie-in-crime to induce admissions from a suspect, but suffice it to say here, the issue is substantial. . . . Yet the fact remains that without the testimony of Chin Poy, counsel for On Lee could not develop a record sufficient to raise and present the issue for decision, and the courts could not evaluate the full impact of such practices upon the rights of an accused or upon the administration of criminal justice.

Lopez v. United States, 373 U.S. 427, 444-45 (1963) (Warren, C.J., concurring in the result) (citations omitted) (footnote omitted).

127. In *Massiah v. United States*, 377 U.S. 201 (1964), the Court would later hold that such government conduct violated the defendant's Sixth Amendment right to counsel. Its facts are virtually identical to *On Lee*'s facts. Massiah faced a federal narcotics indictment. A friend

The majority rejected On Lee's argument that Chin Poy, because he entered the laundry under false pretenses, was a trespasser, making the government's overhearing of the conversation no better than if an officer had secreted himself in a closet to eavesdrop. Justice Jackson held that Chin Poy's entry was consensual, and the fact that On Lee might not have consented had he known Chin Poy's true purpose did not transmute an otherwise lawful entry into an unlawful search for Fourth Amendment purposes.[128] The Court also refused to analogize transmission of conversations to seizure of tangible property, though it never explained why the analogy failed:

> Petitioner relies on cases relating to the more common and clearly distinguishable problems raised where tangible property is unlawfully seized. Such unlawful seizure may violate the Fourth Amendment, even though the entry itself was by subterfuge or fraud rather than force. But such decisions are inapposite in the field of mechanical or electronic devices designed to overhear or intercept conversation, at least where access to the listening post was not obtained by illegal methods.[129]

Had Chin Poy seized tangible evidence (a sample of the opium, perhaps) at an opportune moment when On Lee had turned his back rather than electronically transmitting On Lee's conversation, it is clear that the Court would have suppressed the evidence. That was the situation the Court had faced decades earlier in *Gouled v. United States*.[130]

In order to get evidence against Gouled, military investigators used a supposed friend and business acquaintance of Gouled to retrieve evidence during a visit to Gouled's office. While Gouled was out of the room, the informant seized some papers, which he delivered to his superiors. The Court left no doubt about its disapproval. It pointedly refused to distinguish between seizure resulting from forcible invasion and seizure by stealth.[131]

> The prohibition of the Fourth Amendment is against all unreasonable searches and seizures[,] and if for a government officer to obtain entrance to a man's house or office by force or by an illegal threat or show of force, amounting to coercion, and then to search for and seize his private papers would be an unreasonable and therefore a prohibited search and

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allowed the government to install a transmitter in his car and then engaged Massiah, released on bail, in an incriminating conversation. The majority refused to approve what it characterized as the government's surreptitious interrogation in the absence of Massiah's counsel. *See id.* at 206; *see also* CHARLES H. WHITEBREAD & CHRISTOPHER SLOBOGIN, CRIMINAL PROCEDURE § 16.02, at 410 (4th ed. 2000).

128. *On Lee*, 343 U.S. at 751-52.

129. *Id.* at 753 (citations omitted).

130. 255 U.S. 298 (1921), *overruled in part*, Warden v. Hayden, 387 U.S. 294 (1967) (rejecting *Gouled*'s holding that "mere evidence," i.e. evidence other than fruits or instrumentalities of crime or contraband, was not subject to seizure by search warrant).

131. *Id.* at 305-06.

> seizure, as it certainly would be, it is impossible to successfully contend that a like search and seizure would be a reasonable one if only admission were obtained by stealth instead of by force or coercion. The security and privacy of the home or office and of the papers of the owner would be as much invaded and the search and seizure would be as much against his will in the one case as in the other, and it must therefore be regarded as equally in violation of his constitutional rights.[132]

The unanimous Court therefore held that the seizure violated the Fourth Amendment. The Court has never overruled this part of *Gouled*. *On Lee* was identical to *Gouled* except that the government seized words rather than papers through the false friend. It is possible, therefore, that *On Lee* does little more than reflect the Court's then-continuing reluctance to recognize that the Fourth Amendment protects words as well as tangible objects.[133]

Justice Frankfurter dissented. His first sentence savaged the Court's reasoning as adopting an ends-justify-the-means approach.[134] He attacked *Olmstead* as fundamentally unsound, echoing Justice Brandeis's admonition that ended his dissent in that case[135] and responding to the majority's game metaphor.

> Of course criminal prosecution is more than a game. But in any event it should not be deemed to be a dirty game in which "the dirty business" of criminals is outwitted by "the dirty business" of law officers. The

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132. *Id.*

133. The Court also declined On Lee's request that it rule the evidence inadmissible in the exercise of its supervisory power, and it was in that context that the false-friend discussion occurred. It relied in part on Justice Stone's statement from a quarter century before: "'A criminal prosecution is more than a game in which the government may be checkmated and the game lost merely because its officers have not played according to rule.'" *On Lee*, 343 U.S. at 755 (quoting McGuire v. United States, 273 U.S. 95, 99 (1927)). The Court was unable to find a justification for excluding the evidence on supervisory grounds. "No good reason of public policy occurs to us why the Government should be deprived of the benefit of On Lee's admissions because he made them to a confidante of shady character." *Id.* at 756. At the same time, Justice Jackson did recognize that "[t]he use of informers, accessories, accomplices, false friends, or any of the other betrayals which are 'dirty business' may raise serious questions of credibility[,]" *id.* at 757, but he emphasized that it was only a question of credibility, not one of constitutional law.

134.

> The law of this Court ought not to be open to the just charge of having been dictated by "odious doctrine," as Mr. Justice Brandeis called it, that the end justifies reprehensible means. To approve legally what we disapprove morally, on the ground of practical convenience, is to yield to a short-sighted view of practicality. It derives from a preoccupation with what is episodic and a disregard of long-run consequences. The method by which the state chiefly exerts an influence upon the conduct of its citizens, it was wisely said by Archbishop William Temple, is "the moral qualities which it exhibits in its own conduct."

*Id.* at 758 (Frankfurter, J., dissenting).

135. *See supra* note 61 and accompanying text.

> contrast between morality professed by society and immorality practiced on its behalf makes for contempt of law. Respect for law cannot be turned off and on as though it were a hot-water faucet.[136]

Justices Douglas and Burton also dissented, the latter noting that had a federal officer secreted himself in On Lee's closet, evidence she secured from that vantage point would have been inadmissible. Justice Burton also disagreed with the majority's consent theory, arguing that On Lee had not consented to Chin Poy's broadcasting their conversation and that the presence of the transmitter effectively brought the federal agent's ear into On Lee's house without consent.[137]

With the decision in *On Lee*, the Court permitted the government to do indirectly through a false friend what it could not have done directly. Had the federal official been in the closet, as Justice Burton pointed out, his testimony would have been inadmissible. Similarly, had the agent entered On Lee's house surreptitiously to place a microphone on the premises, the Court would likely not have permitted him to testify as to overheard conversations, the microphone being the functional equivalent of his physical presence and having been placed by means of a trespass.[138] Instead, the government sent the microphone in with Chin Poy, an agent.

The Court announced its next two opinions dealing with false friends on the same day in 1966. In *Lewis v. United States*,[139] the defendant invited an undercover federal narcotics agent who posed as a buyer to his home for the

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136. *On Lee*, 343 U.S. at 758-59 (Frankfurter, J., dissenting).

137. *See id.* at 766 (Burton, J., dissenting). Justice Burton was dealing with a concept that *Katz* would later discuss under the rubric of "reasonable expectation of privacy," though he did not phrase it that way. *See supra* note 90 and accompanying text.

138. In *Goldman v. United States*, 316 U.S. 129 (1942), the Court hinted obliquely that it would have viewed such a situation with constitutional skepticism. Federal officers had unlawfully entered one of the petitioners' offices to install a listening device. When it did not work, the officers listened to conversations instead by placing a device ("detectaphone") against the wall of an adjacent room to which they had lawful access. The Court declined to suppress because it found that the trespass itself did not result in the officers' acquiring evidence.

> The petitioners contend that the trespass committed in Shulman's office when the listening apparatus was there installed, and what was learned as the result of that trespass, was of some assistance on the following day in locating the receiver of the detectaphone in the adjoining office, and this connection between the trespass and the listening resulted in a violation of the Fourth Amendment. Whatever trespass was committed was connected with the installation of the listening apparatus. As respects it, the trespass might be said to be continuing and, if the apparatus had been used, it might, with reason, be claimed that the continuing trespass was the concomitant of its use.

*Id.* at 134-35. Meanwhile, the *Goldman* Court's five-to-three decision strongly reaffirmed *Olmstead*. Chief Justice Stone and Justice Frankfurter joined in dissent to call for overruling *Olmstead*. Justice Murphy also dissented.

139. 385 U.S. 206 (1966).

purpose of engaging in a drug transaction with the defendant.[140] Lewis argued that, there being no warrant, the agent's entry into Lewis's home using fraud and deception violated the Fourth Amendment. The Court was unimpressed. Chief Justice Warren distinguished *Gouled* (but implicitly approved it)[141] because the government agent there had affirmatively misrepresented his purpose, stating he intended only to pay a social call on Gouled.[142] In *Lewis*, by contrast, the defendant had invited the undercover officer to his house for the specific purpose of conducting a drug transaction, and the officer did not see, hear, or seize anything Lewis did not intend.[143]

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140. *Id.* at 207-08.

141. "This Court had no difficulty concluding that the Fourth Amendment had been violated by the secret and general ransacking, notwithstanding that the initial intrusion was occasioned by a fraudulently obtained invitation rather than by force or stealth." *Id.* at 210. The Court explicitly reaffirmed *Gouled* in a case decided the same day as *Lewis*. *See* Hoffa v. United States, 385 U.S. 293, 301 (1966) ("The Fourth Amendment can certainly be violated by guileful as well as by forcible intrusions into a constitutionally protected area." (citing Gouled v. United States, 255 U.S. 298 (1921))).

142. *Lewis*, 385 U.S. at 209.

143. One might rationalize the result in *On Lee* on exactly the same basis, though the *Lewis* Court did not cite *On Lee*. Some circuit court cases have invalidated consensual searches when the government has made an affirmative misrepresentation of the purpose of the search. In *Graves v. Beto*, 424 F.2d 524 (5th Cir. 1970), a police officer told a suspect in a rape case that he wanted to have the suspect's blood tested for alcohol to see if there was enough to hold him on a drunkenness charge. In fact, the purpose of the test was to see whether the suspect's blood type matched blood found at the scene of a rape. The court granted habeas corpus relief. *Id.* at 526; *accord* United States v. Tweel, 550 F.2d 297 (5th Cir. 1977) (holding that IRS agent's misrepresentation of investigation as civil rather than criminal vitiated defendant's consent to turn over papers). *United States v. Andrews*, 746 F.2d 247 (5th Cir. 1984), questioned whether *Schneckloth v. Bustamonte*, 412 U.S. 218 (1973), undermined *Graves*, but it seems clear that it did not. The *Schneckloth* Court ruled that the test for consent was voluntariness and that the police need not advise the person from whom they seek consent of his right to refuse. *Schneckloth*, however, involved no misrepresentation by the police. *See also* United States v. Maldonado Garcia, 655 F. Supp. 1363, 1367 (D.P.R. 1987) (entrance gained by falsely stating that postal inspectors wanted to serve summons):

> It is true that consent is not necessarily vitiated by deception and subterfuge on the part of the police. But officers cannot use a ruse to gain access unless they have more than mere conjecture that criminal activity is underway. To hold otherwise would be to give police a blanket license to enter homes randomly in the hope of uncovering incriminating evidence and information. That this last was the intention of the police in this case is evident from the testimony of Postal Inspector Pacheco[,] who admitted that he did not know if there was any evidence in the apartment, that he was acting solely on an anonymous tip, that he did not have probable cause and that his motivation was to fish for incriminating evidence.

*Id.* (citations omitted). Moreover, a search by consent may not exceed the limits imposed by the consenting party. *See, e.g.*, United States v. Turner, 169 F.3d 84 (1st Cir. 1999) (finding that

The other case was *Hoffa v. United States*.[144] James Hoffa was the president of the Teamsters Union. In 1962, he was a defendant in a federal criminal case. During the trial, he made statements in his hotel room to a co-defendant about tampering with the jury. Partin, a paid informer[145] (who was in the room because he was a Teamsters Union official), overheard the conversations and reported them to the government, which subsequently prosecuted and convicted Hoffa and the other defendants in the original case for attempting to influence jurors. Hoffa objected to the introduction of Partin's evidence as a Fourth Amendment violation, but the trial court overruled the objection, and the Supreme Court affirmed the resulting conviction.[146]

Hoffa argued that Partin's role as a government informer rendered Hoffa's consent for Partin to be in the hotel room ineffective,[147] thus making Partin's conduct a Fourth Amendment violation. The Court refused to go down that path. Justice Stewart's majority opinion made clear that the problem, if any, was not the government agent's invasion of the hotel room, either surreptitiously or by force; it was Hoffa's misplaced reliance on Partin's trustworthiness.[148] The Court also declined to find either a Fifth or Sixth Amendment violation on the facts.[149]

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consent to search house for intruder did not authorize search of computer files or tapes); United States v. Acosta, 110 F. Supp. 2d 918 (E.D. Wis. 2000) (finding that consent to search stated to be for persons does not authorize opening of containers too small to hold a person).

144. 385 U.S. 293 (1966).

145. The government disputed the defendants' assertion that it had placed the informer in the room for the purpose of gathering evidence. The Court declined to reach that factual issue.

> But whether or not the Government 'placed' Partin with Hoffa in Nashville during the Test Fleet trial, we proceed upon the premise that Partin was a government informer from the time he first arrived in Nashville on October 22, and that the Government compensated him for his services as such.

*Id.* at 299.

146. *Id.* at 312.

147. *United States v. Jeffers*, 342 U.S. 48 (1951), had established that hotel rooms are constitutionally protected areas for Fourth Amendment purposes.

148.

> It is obvious that the petitioner was not relying on the security of his hotel suite when he made the incriminating statements to Partin or in Partin's presence. Partin did not enter the suite by force or by stealth. He was not a surreptitious eavesdropper. Partin was in the suite by invitation, and every conversation which he heard was either directed to him or knowingly carried on in his presence. The petitioner, in a word, was not relying on the security of the hotel room; he was relying upon his misplaced confidence that Partin would not reveal his wrongdoing. . . .
>
> Neither this Court nor any member of it has ever expressed the view that the Fourth Amendment protects a wrongdoer's misplaced belief that a person to whom he voluntarily confides his wrongdoing will not reveal it.

*Hoffa*, 385 U.S. at 302 (footnote omitted).

149. *See id.* at 303-12. The Court also decided a third case stemming from the *Hoffa* trial. In

*On Lee*, *Lewis*, and *Hoffa* all antedated *Katz* with its discussion (primarily in Justice Harlan's concurrence) of reasonable expectation of privacy. *United States v. White*[150] offered the Court its first opportunity to evaluate a false-friend case in *Katz*'s light. *White*'s fact pattern is familiar. White had several conversations with a government informant who carried a radio transmitter that broadcasted these conversations to nearby police receivers.[151] The government did not produce the informant at White's trial, and the trial court overruled defense objections to testimony of the government agents who conducted the electronic surveillance.[152]

The case produced no majority opinion. Justice White wrote for the plurality,[153] disapproving the Seventh Circuit's reliance on *Katz* as a basis for excluding the agents' testimony. Remarkably, almost the entire opinion is advisory, but that is the interesting part. The Court had previously held that the "decision in *Katz v. United States* applied only to those electronic surveillances that occurred subsequent to the date of that decision."[154] Since the surveillance in *White* antedated *Katz*, the Court held that the Seventh Circuit had erred in analyzing the case under *Katz*: "The court should have judged this case by the pre-*Katz* law[,] and under that law, as *On Lee* clearly holds, the electronic surveillance here involved did not violate White's rights to be free from unreasonable searches and seizures."[155]

Having castigated the Seventh Circuit for even doing a *Katz* analysis, Justice White performed one of his own, arriving at the opposite conclusion.[156] First, he distinguished *Katz* on the ground that the wiretapping involved was not with the

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*Osborn v. United States*, 385 U.S. 327 (1966), the Court approved the admissibility of a tape recording of a conversation between one of the defense lawyers and a Nashville police officer whom the lawyer had hired to do background checks on prospective jurors. Osborn knew his employee was a police officer; he did not know that the officer, before undertaking the employment, had agreed to report to federal authorities any "'illegal activities' he might observe." *Id.* at 325. However, the recorded conversation followed another conversation that the officer had reported to the federal agents, who then used the officer's affidavit about the contents of the first conversation as the basis for securing a judicial order permitting the recording. That judicial supervision distinguishes *Osborn* from the other false-friend cases.

150. 401 U.S. 745 (1971).

151. Some of the conversations took place in the informant's house. As to those, a police officer hidden in a kitchen closet with the informant's consent also overheard the conversations without the aid of electronic transmission or amplification. *Id.* at 747.

152. *See* United States v. White, 405 F.2d 838, 842 (7th Cir. 1969), *rev'd*, 401 U.S. 745 (1971).

153. One wonders whether Chief Justice Burger's assignment of the plurality opinion in *White* to Justice White was some version of a Freudian slip or reflects instead the Chief Justice's well known elfin sense of humor.

154. United States v. White, 401 U.S. 745, 754 (1971) (citing Desist v. United States, 394 U.S. 244 (1969)).

155. *Id.*

156. This is a fine judicial example of adding insult to injury.

consent of either party to the conversation.[157] Second, he reaffirmed the Court's preceding false-friend cases: *On Lee*, *Lewis*, *Hoffa*, and *Lopez*.[158] Justice White observed that the parties seemed to agree that an undercover agent speaking with a suspect could make notes of the conversation and testify about it without any Fourth Amendment violation.

> For constitutional purposes, no different result is required if the agent[,] instead of immediately reporting and transcribing his conversations with [the] defendant, either (1) simultaneously records them with electronic equipment which he is carrying on his person; (2) or carries radio equipment which simultaneously transmits the conversations either to recording equipment located elsewhere or to other agents monitoring the transmitting frequency. If the conduct and revelations of an agent operating without electronic equipment do not invade the defendant's constitutionally justifiable expectations of privacy, neither does a simultaneous recording of the same conversations made by the agent or by others from transmissions received from the agent to whom the defendant is talking and whose trustworthiness the defendant necessarily risks.[159]

There is a bit of sleight of hand going on Justice White's last sentence. He takes the elided cases, *Lopez* and *On Lee*, to stand for the proposition that the government's activities in those cases invaded no "constitutionally justifiable expectation of privacy," but the Court did not begin to analyze Fourth Amendment cases under the privacy rubric until *Katz*, which postdated both *Lopez* and *On Lee*. Given that Justice White's opinion represents only a plurality, it seems improper for him to ascribe new meaning to those cases.

In any event, Justice White cautioned about an over-expansive reading of the expectation of privacy, almost disposing its subjective component in favor of emphasizing its objective focus.

> Our problem is not what the privacy expectations of particular defendants in particular situations may be or the extent to which they may in fact have relied on the discretion of their companions. . . . Our problem, in terms of the principles announced in *Katz*, is what expectations of privacy are constitutionally "justifiable"—what expectations the Fourth Amendment will protect in the absence of a warrant.[160]

He went on to illustrate, one assumes unwittingly, a real problem with his reading of *Katz*'s test. "Inescapably, one contemplating illegal activities must realize and risk that his companions may be reporting to the police. . . . [I]f he has no doubts,

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157. *White*, 401 U.S. at 749.

158. *Id.* at 749-50.

159. *Id.* at 751 (citations omitted).

160. *Id.* at 751-52.

or allays them, or risks what doubt he has, the risk is his."[161] The underlying, unstated assumption of that sentiment is that those who wrote and ratified the Fourth Amendment did not intend it to protect or help conceal unlawful activities. Although that assumption is probably true, it misses the point. The Fourth Amendment exists to protect people's privacy against unwarranted government intrusion, and it was at that evil that the former colonists aimed.[162] The protection is not absolute, but it is circumscribed by the Fourth Amendment's inclusion of the reasonableness and probable cause requirements. The harm that the Amendment protects against is the loss of the sense of security that inevitably accompanies the idea that no matter where one is, and no matter what one does, the government may be listening or watching.

It is a bit too facile to think only the wrongdoer fears that the government will take notice. A person taking a shower may have nothing criminal to conceal, but it seems unlikely that such a person would be sanguine about having uninvited, surreptitious observers, whether governmental or not.[163] The difference is one of degree, not kind. Several states have reflected exactly this concern by prohibiting surveillance of changing rooms in retail stores,[164] and all states make criminal the sort of activities associated with Peeping Toms.[165]

The law recognizes that concern about disclosure of conversations causes people to restrict their communication artificially (although the *White* plurality denied such a connection).[166] The well known testimonial privileges—doctor-patient,[167] husband-wife,[168] clergy-penitent[169] and lawyer-client[170]—do not exist

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161. *Id.* at 752.

162. "The overriding function of the Fourth Amendment is to protect personal privacy and dignity against unwarranted intrusion by the State." Schmerber v. California, 384 U.S. 757, 767 (1966). Query whether Justice Brennan used the word "unwarranted" in its literal sense, to mean without a warrant. "[T]he Fourth Amendment is intended to protect personal privacy rather than to prevent the conviction of criminals." LAFAVE ET AL., *supra* note 2, § 3.9(b), at 231.

163. I am indebted to Justice Stevens for this observation. "A bathtub is a less private area when the plumber is present even if his back is turned." Karo v. United States, 468 U.S. 705, 735 (1984) (Stevens, J., concurring and dissenting).

164. *See, e.g.*, CAL. PENAL CODE § 653n (West 1999); FLA. STAT. ANN. § 877.26 (West 2005); MD. CODE ANN., §§ 3-901 to 3-903 (Michie 2002 & West 2004); N.Y. GEN. BUS. LAW § 395-b (McKinney Supp. 2005).

165. *See, e.g.*, FLA. STAT. § 810.145 (West 2005); N.C. GEN. STAT. § 14-202 (West 2004); OKLA. STAT. tit. 21, § 1171 (2002); VA. CODE. ANN. § 18.2-130 (West 2004).

166.

> Given the possibility or probability that one of his colleagues is cooperating with the police, it is only speculation to assert that the defendant's utterances would be substantially different or his sense of security any less if he also thought it possible that the suspected colleague is wired for sound.

*White*, 401 U.S. at 752. There is no indication of whether Justice White was able to suppress a giggle when he wrote this.

167. *See generally* ROGER C. PARK ET AL., EVIDENCE LAW § 8.13, at 441-44 (2d ed. 2004); Martha M. Kendrick et al., *The Physician-Patient, Psychotherapist-Patient, and Related Privileges*,

to protect wrongdoers; the privileges exist in recognition that people will be inhibited if they know that their communications to others may go not merely to the intended recipient, but to the world.[171]

Justice Harlan's dissent focused in part on exactly that problem. To him, it was obvious:

> Authority is hardly required to support the proposition that words would be measured a good deal more carefully and communication inhibited if one suspected his conversations were being transmitted and transcribed. Were third-party bugging a prevalent practice, it might well smother that spontaneity—reflected in frivolous, impetuous, sacrilegious, and defiant discourse—that liberates daily life.[172]

Justice White's plurality took the view that the difference between a conversational partner deciding to tell the government about a conversation and recording or transmitting the conversation itself was a matter of form, not substance. Justice Harlan disputed that assertion.

> The force of the contention depends on the evaluation of two separable but intertwined assumptions: first, that there is no greater invasion of privacy in the third-party situation, and, second, that uncontrolled consensual surveillance in an electronic age is a tolerable technique of

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*in* 1 TESTIMONIAL PRIVILEGES §§ 7:01-7:34, at 7-3 to -56 (David M. Greenwald et al. eds., 3d ed. 2005).

168. *See generally* PARK ET AL., *supra* note 167, §§ 8.15-8.17, at 446-52; Edward F. Malone & Claudia Gallo, *Spousal Privileges*, *in* 1 TESTIMONIAL PRIVILEGES, *supra* note 167, §§ 5:01-5:14, at 5-2 to -43.

169. *See generally* PARK ET AL., *supra* note 167, § 8.20, at 458; David W. Austin & Donald S. Boyce, Jr., *The Clergy Communications Privilege*, *in* 1 TESTIMONIAL PRIVILEGES, *supra* note 167, §§ 6:1-6:14, at 6-1 to -54.

170. *See generally* Upjohn Co. v. United States, 449 U.S. 383, 389 (1981) (noting that the privilege's "purpose is to encourage full and frank communication between attorneys and their clients and thereby promote broader public interests in the observance of law and administration of justice"); David M. Greenwald et al., *The Attorney-Client Privilege*, *in* 1 TESTIMONIAL PRIVILEGES, *supra* note 167, §§ 1:01-1:98, at 1-5 to -404.

171. *See, e.g.*, Trammel v. United States, 445 U.S. 40, 51 (1980) ("[T]he physician must know all that patient can articulate in order to identify and to treat disease; barriers to full disclosure would impair diagnosis and treatment."); *id.* (noting that the spousal privilege protects confidential communications and fosters marital harmony); *id.* ("The priest-penitent privilege recognizes the human need to disclose to a spiritual counselor, in total and absolute confidence, what are believed to be flawed acts or thoughts and to receive priestly consolation and guidance in return."); *id.* ("The lawyer-client privilege rests on the need for the advocate and counselor to know all that relates to the client's reasons for seeking representation if the professional mission is to be carried out.").

172. United States v. White, 401 U.S. 745, 787 (1971) (Harlan, J., dissenting) (footnote omitted).

law enforcement, given the values and goals of our political system."[173]

He focused on the value that he saw reflected in the Fourth Amendment: "the individual's sense of security."[174] Justice Harlan made it clear that he meant every individual in the society, not simply those (upon whom the plurality focused) engaged in wrongdoing.

> Finally, it is too easy to forget—and, hence, too often forgotten—that the issue here is whether to interpose a search warrant procedure between law enforcement agencies engaging in electronic eavesdropping and the public generally. By casting its "risk analysis" solely in terms of the expectations and risks that "wrongdoers" or "one contemplating illegal activities" ought to bear, the plurality opinion, I think, misses the mark entirely. *On Lee* does not simply mandate that criminals must daily run the risk of unknown eavesdroppers prying into their private affairs; it subjects each and every law-abiding member of society to that risk. The very purpose of interposing the Fourth Amendment warrant requirement is to redistribute the privacy risks throughout society in a way that produces the results the plurality opinion ascribes to the *On Lee* rule. Abolition of *On Lee* would not end electronic eavesdropping. It would prevent public officials from engaging in that practice unless they first had probable cause to suspect an individual of involvement in illegal activities and had tested their version of the facts before a detached judicial officer. The interest *On Lee* fails to protect is the expectation of the ordinary citizen, who has never engaged in illegal conduct in his life, that he may carry on his private discourse freely, openly, and spontaneously without measuring his every word against the connotations it might carry when instantaneously heard by others unknown to him and unfamiliar with his situation or analyzed in a cold, formal record played days, months, or years after the conversation. Interposition of a warrant requirement is designed not to shield "wrongdoers," but to secure a measure of privacy and a sense of personal security throughout our society.[175]

In effect, Justice Harlan suggested that the plurality overlooked that the Fourth Amendment has a heavy component of collective, not merely individual, protection.

The Fourth Amendment exists in large part in reaction to the general searches and writs of assistance that had plagued the colonists in the period leading up to the revolution.[176] The untrammeled use of British power to search for crime

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173. *Id.* at 785.

174. *Id.* at 786.

175. *Id.* at 789-90.

176. *See, e.g.*, United States v. Rabinowitz, 339 U.S. 56, 69 (1950) (Frankfurter, J., dissenting) (noting "the central fact about the Fourth Amendment, namely, that it was a safeguard against recurrence of abuses so deeply felt by the Colonies as to be one of the potent causes of the

without focused and factually supported suspicion motivated the new nation to recognize the society-damaging effects of executive power not subject to neutral—judicial—control. The major cost of government behavior such as that in *White* is borne not primarily by the individual upon whom the government focuses; it is borne by the rest of society, which must worry that government overreaching, which the Framers certainly regarded as endemic to the institution of government,[177] may bring us within its ambit. As Professor Amsterdam pointed out:

> The evil [addressed by the Framers] was general: it was the creation of an administration of public justice that authorized and supported indiscriminate searching and seizing. It was against such a regime of public justice that the fourth amendment was set. I do not think that the phraseology of the amendment, akin to that of the first and second amendments and the ninth, is accidental. It speaks of "[t]he right of the people to be secure in their persons, houses, papers, and effects, against unreasonable searches and seizures." The vice of a system of criminal justice that relies upon a professional police and admits evidence they obtain by unreasonable searches and seizures is precisely that we are all thereby made less secure in our persons, houses, papers and effects against unreasonable searches and seizures.[178]

The Court has recognized the Fourth Amendment's collective aspect. In a series of cases refusing to apply the exclusionary rule in response to clearly unconstitutional conduct, the Court explained that the rule exists to protect the collective interest against government overreaching. Therefore, it argued, if applying the rule would have limited deterrent effect, the courts should not

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Revolution"); Barbara C. Salken, *The General Warrant of the Twentieth Century? A Fourth Amendment Solution to Unchecked Discretion to Arrest for Traffic Offenses*, 62 TEMPLE L. REV. 221, 254 (1989):

> The fourth amendment was designed to prevent the arbitrary and indiscriminate searches permitted by general warrants and writs of assistance. General warrants and writs of assistance were harmful because they delegated to the officer the power to decide whom to search and for what to search. They granted the power to search without a showing of individualized suspicion that evidence of criminal activity would be found in a particular place.

*See also* Scott E. Sundby, *Protecting the Citizen "Whilst He Is Quiet": Suspicionless Searches, "Special Needs" and General Warrants*, 74 MISS. L.J. 501, 506-15 (2004).

177. *See generally* GORDON S. WOOD, THE CREATION OF THE AMERICAN REPUBLIC 1776-1787 (1998). It is that recognition that inspired Lord Acton's famous comment: "Power tends to corrupt and absolute power corrupts absolutely." Letter from John E.E. Dalberg-Acton (Lord Acton) to Bishop Mendell Creighton (Apr. 5, 1887), *reprinted in* JOHN EMERICH EDWARD DALBERG-ACTON, ESSAYS ON FREEDOM AND POWER 364 (G. Himmelfarb ed., The Free Press 1972).

178. Anthony G. Amsterdam, *Perspectives on the Fourth Amendment*, 58 MINN. L. REV. 349, 432-33 (1974).

suppress the evidence.[179]

These concerns have never been more appropriate than today. Congress passed the USA Patriot Act[180] in haste in 2001 as a response to the terrorist attacks of September 11. Both houses have now voted to renew it with no major modifications.[181] Criticisms of the Patriot Act have focused on its insulation of executive practice from meaningful judicial review and the threats to individual privacy that inhere in the government's vastly expanded surveillance powers.[182] On July 21, 2005, the New York City Police Department began randomly searching bags and parcels carried by anyone using public transportation, promising to deny access to anyone who refused.[183] New York's Metropolitan

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179. *See, e.g.*, United States v. Calandra, 414 U.S. 338, 347-48 (1974) (citation omitted):

> The purpose of the exclusionary rule is not to redress the injury to the privacy of the search victim:
> "The ruptured privacy of the victims' homes and effects cannot be restored. Reparation comes too late."
>
> Instead, the rule's prime purpose is to deter future unlawful police conduct and thereby effectuate the guarantee of the Fourth Amendment against unreasonable searches and seizures.
>
> . . . .
>
> In sum, the rule is a judicially created remedy designed to safeguard Fourth Amendment rights generally through its deterrent effect, rather than a personal constitutional right of the party aggrieved.

*See generally* Doernberg, *supra* note 82, at 282-97.

180. Uniting and Strengthening America to Provide Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001, Pub. L. No. 107-56, 115 Stat. 272 (2001).

181. *See* Eric Lichtblau, *Senate Makes Permanent Nearly All Provisions of Patriot Act, with a Few Restrictions*, N.Y. TIMES, July 30, 2005, at A11; Eric Lichtblau, *House Votes for a Permanent Patriot Act*, N.Y. TIMES, July 22, 2005, at A11.

182. *See, e.g.*, Patricia Mell, *Big Brother at the Door: Balancing National Security with Privacy Under the USA Patriot Act*, 80 DENV. U.L. REV. 375 (2002); Jeremy C. Smith, *The USA Patriot Act: Violating Reasonable Expectations of Privacy Protected by the Fourth Amendment Without Advancing National Security*, 82 N.C. L. REV. 412 (2003); John W. Whitehead & Steven H. Aden, *Forfeiting "Enduring Freedom" for "Homeland Security": A Constitutional Analysis of the USA Patriot Act and the Justice Department's Anti-Terrorism Initiatives*, 51 AM. U. L. REV. 1081 (2002). James Madison also warned of the dangers the Patriot Act poses, though he could not have appreciated it at the time: "Perhaps it is a universal truth that the loss of liberty at home is to be charged to provisions against danger, real or pretended, from abroad." Letter from James Madison to Thomas Jefferson (May 13, 1798), *reprinted in* PHILIP B. HEYMANN, TERRORISM, FREEDOM, AND SECURITY: WINNING WITHOUT WAR, at xi (2003). At the time, Madison was speaking of the Alien and Sedition Acts of 1798, but his words apply equally well to the legislation of two centuries later.

183. Sewell Chan & Kareem Fahim, *New York Starts to Inspect Bags on the Subways*, N.Y.

Transportation Authority, which runs commuter trains to and from the city, announced that it would begin doing the same thing.[184] Some have asserted that the practice violated the Constitution.[185] Boston officials welcomed the 2004 Democratic National Convention by announcing that they would conduct random searches of passengers using that city's transit system, which provoked a court challenge.[186]

It turns out that those relatively limited government operations are but the tip of the iceberg. On December 15, 2005, the New York Times published an article about a presidential initiative that had apparently been going on for three years and may be far broader and more chilling in its application and effects.

> Months after the Sept. 11 attacks, President Bush secretly authorized the National Security Agency [hereinafter "NSA"] to eavesdrop on Americans and others inside the United States to search for evidence of terrorist activity without the court-approved warrants ordinarily required for domestic spying, according to government officials.
>
> Under a presidential order signed in 2002, the intelligence agency has monitored the international telephone calls and international e-mail messages of hundreds, perhaps thousands, of people inside the United States without warrants over the past three years in an effort to track possible "dirty numbers" linked to Al Qaeda, the officials said. The

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TIMES, July 22, 2005, at A1. It is not clear how the City will make such searches constitutional in light of *Delaware v. Prouse*, 440 U.S. 648 (1979), in which the Court declared a random stop of a vehicle, with neither probable cause nor reasonable suspicion to believe that any violation had occurred, violated the Fourth Amendment. *See* Terry v. Ohio, 392 U.S. 1, 21 (1968) (authorizing limited stops of individuals on the street and pat-downs of their outer clothing if the police have reasonable suspicion, based on "specific and articulable facts" that crime is afoot). Justice White noted, however, that it was the randomness of the stop that offended the Constitution.

> This holding does not preclude the State of Delaware or other States from developing methods for spot checks that involve less intrusion or that do not involve the unconstrained exercise of discretion. Questioning of all oncoming traffic at roadblock-type [sic] stops is one possible alternative. We hold only that persons in automobiles on public roadways may not for that reason alone have their travel and privacy interfered with at the unbridled discretion of police officers.

*Prouse*, 440 U.S. at 663 (footnote omitted). The Court did not attempt to explain how, if it is unconstitutional to stop a single vehicle without probable cause or reasonable suspicion, it might nonetheless be constitutional to stop every vehicle without probable cause or reasonable suspicion. On the other hand, the Court has held that a Border Patrol agent's simple act of feeling the outside of a bus passenger's soft-sided luggage to attempt to discern whether the passenger was carrying contraband violated the Fourth Amendment. Bond v. United States, 529 U.S. 334 (2000). This may pose a problem for the New York plan.

184. Chan & Fahim, *supra* note 183.

185. *See* Robert F. Worth, *Privacy Rights Are at Issue in New Policy on Security*, N.Y. TIMES, July 22, 2005, at B5.

186. *Id.*

> agency, they said, still seeks warrants to monitor entirely domestic communications.[187]

That report set off a cascade of follow-up reports as public officials and private individuals reacted to the news.[188] "A federal judge . . . resigned from the court that oversees government surveillance in intelligence cases in protest of President Bush's secret authorization of a domestic spying program. . . ."[189] The Justice Department announced that it would investigate not the legality of the program, but rather whether those who revealed the program's existence to the New York Times committed criminal acts in doing so.[190] The Washington Post raised the possibility that NSA was conducting domestic surveillance even before President Bush purported to authorize it.[191] The Foreign Intelligence Surveillance Court asked for an explanation of the program and the authority for it out of concern that its own proceedings might have been tainted by unknowing receipt of evidence traceable back to NSA spying.[192] The chairman of the Senate Judiciary Committee decided to hold hearings to consider whether the President acted illegally.[193] For its part, the executive branch refused requests from the Senate

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187. James Risen & Eric Lichtblau, *Bush Lets U.S. Spy on Callers Without Courts*, N.Y. TIMES, Dec. 15, 2005, at A1. The revelation of the spying program was not the only unusual thing about the article. The reporters also revealed that the *Times* had withheld publication for a year under pressure from the White House and ultimately omitted some of the story because of administration-expressed security concerns. *See id.*

188. *See, e.g.*, Peter Baker & Charles Babington, *Bush Addresses Uproar over Spying*, WASH. POST, Dec. 20, 2005, at A1; Dan Eggen & Charles Lane, *On Hill, Anger and Calls for Hearings Greet News of Stateside Surveillance*, WASH. POST, Dec. 17, 2005, at A1; Barton Gellman & Dafna Linzer, *Pushing the Limits of Wartime Powers*, WASH. POST, Dec. 18, 2005, at A1.

189. Carol D. Leonnig & Dafna Linzer, *Spy Court Judge Quits in Protest*, WASH. POST, Dec. 21, 2005, at A1.

190. Echoes of the Pentagon Papers case from the Viet Nam War era are unmistakable. See *New York Times Co. v. United States*, 403 U.S. 713 (1971), which "confirmed the weight of First Amendment principles and the importance of airing information potentially critical of the government, despite drastic security, military, and diplomatic repercussions." Elana J. Zeide, *In Bed with the Military: First Amendment Implications of Embedded Journalism*, 80 N.Y.U. L. REV. 1309, 1329 (2005).

191. *See* Dafna Linzer, *Secret Surveillance May Have Occurred Before Authorization*, WASH. POST, Jan. 4, 2006, at A3.

192. *See* Carol D. Leonnig, *Surveillance Court Is Seeking Answers*, WASH. POST, Jan. 5, 2006, at A2.

193. *See* Douglas Jehl, *Specter Vows a Close Look at Spy Program*, N.Y. TIMES, Jan. 16, 2006, at A11.

Whether the President acted legally or not is for now a matter of public debate. *See, e.g.*, Noah Feldman, *Deliberation Nation*, N.Y. TIMES, Feb. 5, 2006, § 6, at 17. In 1972, the Supreme Court held in *United States v. United States District Court*, 407 U.S. 297 (1972), a unanimous Court (Justice Rehnquist not participating) held that electronic surveillance in domestic security matters was constitutional only if conducted pursuant to the Fourth Amendment's warrant

Committee for Justice Department opinion documents,[194] and there the matter rests at this writing. Justice Harlan's concerns and Professor Amsterdam's warning about uncontrolled government spying making every member of society less secure seem to be mere speculation no longer.

Whether one is addressing random stops of transit passengers, police practices of recruiting and using false friends to accomplish what the police presumably cannot do for themselves, or the President's NSA spying program, the underlying question is what kind of society the Constitution contemplates. Recent police practices in New York and Boston seem to envision a society in which the contents of one's parcels are not private whenever one is in a public place. The false-friend cases apparently countenance a society in which one speaks to another person only if one is willing to accept the risks that the

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procedure. *Id.* at 321. The Court expressly did not consider the extent of presidential surveillance power with respect to "the activities of foreign powers, within or without this country." *Id.* at 308, 321-22. In 1978, Congress passed the Foreign Surveillance Intelligence Act, Pub. L. No. 95-511, 92 Stat. 1783 (1978) (codified as amended at 50 U.S.C. §§ 1801-1811 (2000)) [hereinafter "FSIA"]. That statute addresses part of the question that the Court reserved by requiring warrants for electronic surveillance of anyone in the United States. *See* 50 U.S.C. § 1802 (2000). To the extent that NSA has without warrants been intercepting communications involving at least one person within the United States, it appears that such activity violates FSIA, which was foresighted enough to provide that electronic surveillance except as authorized by statute is a prohibited activity. *See* 50 U.S.C. § 1809 (2000).

The Government's response has been to argue that both Congress's Authorization for Use of Military Force, Pub. L. No. 107-40, 115 Stat. 224 (2001), enacted in the immediate aftermath of the September 11 terrorist attack on the United States, and the Constitution's designation of the President as commander-in-chief of the military allow the President to take any actions he deems necessary to protect the nation from terrorism.

> [T]he administration argues that another law, the Sept. 18, 2001, Authorization for Use of Military Force, superseded FISA: by giving the president the power to make war against Al Qaeda and its supporters, the argument goes, the law implicitly authorized the customary activities of war, including a wide variety of intelligence gathering. When challenged on this point, the administration's next line of defense is the Constitution: the president's responsibility as commander in chief and his executive power over foreign affairs are said to entail the authority to listen to conversations across borders that are relevant to national security.

Feldman, *supra*, at 17. There are some difficulties with the administration's arguments. First, the administration implicitly argues that the restrictions of FSIA are unconstitutional as a matter of separation of powers. Second, as the Supreme Court has repeatedly admonished, repeals by implication (in this case of portions of FSIA by the 2001 Authorization) are disfavored. *See, e.g.*, Allen v. McCurry, 449 U.S. 90, 99 (1980); Schlesinger v. Councilman, 420 U.S. 738, 752 (1975). Resolution of this debate is beyond the scope of this Article. The important thing, for present purposes, is the Government's assertion of a constitutional entitlement to conduct surveillance of persons within the United States without constraint from the Fourth Amendment.

194. *See* Eric Lichtblau, *Panel Rebuffed on Documents on U.S. Spying*, N.Y. TIMES, Feb. 2, 2006, at A1.

individual may already be acting as a government agent and informer and that the government may be listening in on the conversation. The Court's position is that everyone is charged with the knowledge that when they speak, they may be speaking to the government. The President's position appears to be that his Article II powers as commander-in-chief, combined with Congress's authorization of military force following the September 11 attacks, allow him to ignore other parts of the Constitution. The world has witnessed such societies in the recent past, but they have not been located on the North American continent[195] or purportedly functioning under the U.S. Constitution. There is, however, an even larger problem, which flows from the confluence of the Court's assumption-of-risk approach and its expectation-of-privacy analysis as the Court has interpreted it since *Katz*. Part III addresses the logical *dénouement* of that meeting.

## III. TAKING THE COURT'S FOURTH AMENDMENT CASES SERIOUSLY: THE IRON LAW OF (UN?)INTENDED CONSEQUENCES

The Court has made clear that the Fourth Amendment protects only reasonable expectations of privacy. If there is no reasonable expectation of privacy, there is no Fourth Amendment protection. Cases like *Smith v. Maryland*[196] and *United States v. Miller*[197] make that clear. The Court has taken the same approach in the false-friend cases.[198] It is important to focus on exactly what makes the reasonable expectation of privacy disappear: it is not the fact that one's listener is cooperating with the government; it is the risk that he may be. The risk, of course, is always present. If it is the risk that causes the reasonable expectation of privacy to evaporate, however, then there can be no expectation of privacy whenever one is talking to another person, whether or not that person is in fact acting as an informer. What is to stop the police from eavesdropping on

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195. *See, e.g.*, Joachim J. Savelsberg, *Contradictions, Law, and State Socialism*, 25 LAW & SOC. INQUIRY 1021, 1030 (2000):

> [A]n extensive informant system aided the policing of Soviet society. In extreme periods such as the late 1920s, 10% of the population was recruited as full-time informers, and 30-60% of the population was forced to cooperate in undercover work of the security police. An additional percentage was coopted [sic] into the militia's undercover operations.

*See also* W.W. Rostow, THE DYNAMICS OF SOVIET SOCIETY 200 (1967) (emphasis added):

> The power of the police has . . . been directly felt by various ethnic and other groups considered, at one time or another, politically unreliable. More generally, the "secret sections" set up within offices, factories, military units, and other organizations, and the forced recruiting of *vast numbers of citizens as informers*, bring home the existence of the secret police to the people at large, even when the average unskilled factory or farm worker may live out his life without becoming personally involved.

196. 442 U.S. 735 (1979); *see supra* notes 100-08 and accompanying text.

197. 425 U.S. 435 (1976); *see supra* notes 110-15 and accompanying text.

198. *See supra* notes 125-74 and accompanying text.

any conversation, circumventing the protection that the Fourth Amendment would otherwise offer, by arguing that there was no reasonable expectation of privacy because the listener *might have been* wired or otherwise cooperating with the police?

It is tempting to respond that the risk the speaker assumed was that his *listener* would turn out to be a false friend, not that the police might unilaterally have decided to use technology to listen in on the conversation. That response, however, requires recognition of a relative expectation of privacy,[199] something the Court has resolutely refused to do. Privacy and the reasonable expectation of privacy are all-or-nothing matters; one either has them or not. That was the thrust of Justice Marshall's dissent in *Smith*.[200] The fact remains, however, that it was a dissent. Both in *Smith* and *United States v. Miller*[201] the Court took the position that once the individual delivers information to someone else, whether in digital or paper form, she loses any expectation of privacy that she might theretofore have enjoyed.[202] The false-friend cases demonstrate that this is true of oral communications as well. Moreover, *Miller* is particularly important because it makes clear that the loss of privacy is unrelated to the information recipient's voluntary transmission of the information to third parties. In *Miller*, the government had subpoenaed the defendant's bank records; the bank had not sought out the government or otherwise volunteered to cooperate with it.[203] The Court elided the distinction between willing and unwilling revelation:

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199. *See supra* text accompanying notes 103-09.

200. *See supra* text accompanying note 104.

201. 425 U.S. 435 (1976).

202. *See supra* notes 110-15 and accompanying text.

203. *Miller*, 425 U.S. at 436. *Miller* argued, inter alia, that the subpoenas were defective in form. The Court rejected his position, finding "that there was no intrusion into any area in which respondent had a protected Fourth Amendment interest . . . ." *Id.* at 440. In effect, the Court was holding that Miller had no standing to object, since the records did not belong to him (even though they reflected his financial dealings). Two years later, however, the Court urged abandoning the vocabulary of standing in Fourth Amendment cases in favor of the direct substantive inquiry:

> [T]he question necessarily arises whether it serves any useful analytical purpose to consider this principle a matter of standing, distinct from the merits of a defendant's Fourth Amendment claim. We can think of no decided cases of this Court that would have come out differently had we concluded, as we do now, that the type of standing requirement discussed in *Jones* and reaffirmed today is more properly subsumed under substantive Fourth Amendment doctrine. Rigorous application of the principle that the rights secured by this Amendment are personal, in place of a notion of "standing," will produce no additional situations in which evidence must be excluded. The inquiry under either approach is the same. But we think the better analysis forthrightly focuses on the extent of a particular defendant's rights under the Fourth Amendment, rather than on any theoretically separate, but invariably intertwined concept of standing.

Rakas v. Illinois, 439 U.S. 128, 138-39 (1978) (footnote omitted). One might regard *Miller* as a forerunner of *Rakas*'s approach.

> The depositor takes the risk, in revealing his affairs to another, that the information will be conveyed by that person to the Government. This Court has held repeatedly that the Fourth Amendment does not prohibit the obtaining of information revealed to a third party and conveyed by him to Government authorities, even if the information is revealed on the assumption that it will be used only for a limited purpose and the confidence placed in the third party will not be betrayed.[204]

It is noteworthy that *White*, *Hoffa*, and *Lopez*, which the Court cited, all involved circumstances in which the listener was not compelled by process to reveal the information. Be that as it may, *Miller* and the precedents that underlie it make clear that under the Court's Fourth Amendment analysis, one divulges information to almost anyone at his own risk, and the risk is not simply that the recipient of the information will decide (or has previously decided) to share the information with the government, but rather that the government will seize the information. Whether the seizure is by subpoena or uninvited eavesdropping is, given *Miller*'s rationale, of no constitutional importance.

The upshot is that the government may eavesdrop on or intercept any conversation that takes place outside of an area that the government has no right to enter.[205] The government need have neither probable cause nor reasonable suspicion to do so, because, according to the Court, there are no Fourth Amendment interests involved. For that matter, there may be no constitutional impediment to the government intercepting conversations that take place within what the Court still calls a "constitutionally protected area"[206]—the home—despite *Katz*'s admonition that the term focuses on the wrong issues,[207] as long as the government does not depend upon an illegal entry to do so. After all, if revealing information to another person causes the reasonable expectation of privacy to disappear, what difference does it make whether the government overhears a conversation taking place in a restaurant or the defendant's home?[208]

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204. *Miller*, 425 U.S. at 443 (citation omitted) (citing United States v. White, 401 U.S. 745, 751-52 (1971); Hoffa v. United States, 385 U.S. 293, 302 (1966); Lopez v. United States, 373 U.S. 427 (1963)).

205. Presumably, the government could not enter a private home or office for the purpose of placing a transmitter on the premises, because such an intrusion would itself be a Fourth Amendment violation, and conversations intercepted as a result of it would be suppressible fruits. *See* Wong Sun v. United States, 371 U.S. 471 (1963).

206. *See, e.g.*, Kyllo v. United States, 533 U.S. 27, 34 (2001) (citing Silverman v. United States, 365 U.S. 505 (1961)); United States v. Knotts, 460 U.S. 276, 286 (1983).

207. *See supra* text accompanying notes 77-82.

208. At this point, of course, the ghost of the Court's cases dealing with physical trespass smiles grotesquely in the background. Suppose, however, that no trespass occurs. As *Kyllo* demonstrates, technology now makes it possible to detect from outside a home things that occur within the home. With respect to conversations, it may be entirely possible to detect the contents of a conversation inside a house by electronic capture of sound vibrations, just as in *Kyllo*, where the police equipment detected an unusual heat source within the building. *Kyllo*, 533 U.S. at 29-30.

## IV. THE COURT'S MUDDLED VIEW OF PRIVACY AS AN ALL-OR-NOTHING CONCEPT

The progression from what the Court has always found constitutionally improper to what it now recognizes as permissible under the Fourth Amendment is not nearly as clear-cut as the Court would like everyone to believe. From *Boyd v. United States*[209] forward, the Court has disapproved collection of evidence facilitated by trespass. In addition, even where there was no trespass because the person who seized the evidence had been invited into the private area, the Court refused to admit physical evidence taken surreptitiously.[210] In *Olmstead*, while ruling evidence obtained by wiretapping admissible, the Court relied on two grounds: one, that spoken words were not within the class of things that the Fourth Amendment protects; and the other, that there had been no trespass committed in order to acquire the information.[211] *Olmstead* implied that if a government agent enters the defendant's home or office undetected and without permission and hides in order to hear the defendant's conversations, the Court would suppress the agent's testimony. Justice Burton's dissent in *On Lee v. United States*[212] confirmed this view, as did the Court's decision in *Silverman v. United States*,[213] when the Justices condemned physical intrusion, no matter how minimal.[214]

Moreover, the Court has ruled "that obtaining by sense-enhancing technology

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Wiretapping, of course, has never required physical entry, as *Olmstead* recognized. Olmstead v. United States, 277 U.S. 438, 457 (1928), *overruled in part by* Katz v. United States, 389 U.S. 347 (1957) *and* Berger v. New York, 388 U.S. 41 (1957).

209. 116 U.S. 616 (1886), *overruled in part by* Fisher v. United States, 425 U.S. 391 (1976); *see supra* notes 4-10, 19-23 and accompanying text.

210. *See* Gouled v. United States, 255 U.S. 298 (1921), *overruled in part by* Maryland Penitentiary v. Hayden, 387 U.S. 294 (1957); *see supra* notes 130-33 and accompanying text.

211. *Olmstead*, 277 U.S. at 464, 466.

212. 343 U.S. 747, 765-66 (1952) (Burton, J., dissenting) (emphasis added):

> It seems clear that if federal officers without warrant or permission enter a house, under conditions amounting to unreasonable search, and there conceal themselves, the conversations they thereby overhear are inadmissible in a federal criminal action. It is argued that, in the instant case, there was no illegal entry because petitioner consented to Chin Poy's presence. This overlooks the fact that Chin Poy, without warrant and without petitioner's consent, took with him the concealed radio transmitter to which agent Lee's receiving set was tuned. For these purposes, *that amounted to Chin Poy surreptitiously bringing [federal agent] Lee with him.*

*See supra* notes 112-24 and accompanying text.

213. 365 U.S. 505 (1961); *see supra* notes 67-70 and accompanying text.

214. Recall that in *Goldman v. United States*, 316 U.S. 129 (1942), the Court had approved use of a speech detection device placed *against* a wall but not penetrating it. *See supra* note 62 and accompanying text. The *Silverman* Court noted, "We find no reason to re-examine *Goldman* here, but we decline to go beyond it, by even a fraction of an inch." *Silverman*, 365 U.S. at 512.

any information regarding the interior of the home that could not otherwise have been obtained without physical 'intrusion into a constitutionally protected area' constitutes a search . . . where . . . the technology in question is not in general public use."[215] The question, of course, is what constitutes general public use. Binoculars clearly do;[216] infrared heat sensors do not.[217] The Court has held that both some aerial photography[218] and electronic tracking devices[219] are sufficiently common that their use does not constitute a Fourth Amendment search. On the other hand, a tracking device that permits police to determine exactly where a particular object is inside a private house does constitute a search,[220] and Justice O'Connor's concurrence in one of the aerial surveillance cases suggested that some aerial observations might be sufficiently intrusive to be a Fourth Amendment search.[221] One of the difficulties that the Court's approach invites is that as technology becomes more and more sophisticated, it also tends to become more and more common. The Court's general-public-use standard may have the effect of constricting Fourth Amendment protection of privacy over time, as the public adopts technologies once restricted to the laboratory or the military (e.g. aerial photography).

Consider now some variations on the themes that the Court has confronted. In *On Lee*, suppose that Chin Poy, the informer, had stealthily admitted a government agent to the house and directed him to a nearby closet when On Lee's back was turned. It seems beyond question that the Court would suppress the agent's testimony as to conversations he overheard. And yet, in the same way that the Court tells us that one assumes the risk in speaking with someone that he may tell the government (or be wired for sound at the time of the conversation), does one not risk, when admitting someone to the home, that the guest will subsequently open the door for others to enter without the host's permission? Under the Court's Fourth Amendment jurisprudence, it is no answer to say that the house guest lacks the authority to admit uninvited people to the home. In the false-friend cases, the defendants certainly had not authorized their confidantes to record or transmit conversations, but the Court brushed aside the idea of

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215. Kyllo v. United States, 533 U.S. 27, 34 (2001) (citation omitted).

216. *See, e.g.*, United States v. Grimes, 426 F.2d 706 (5th Cir. 1970); Fullbright v. United States, 392 F.2d 432 (10th Cir. 1968).

217. *Kyllo*, 533 U.S. at 34.

218. *See* Dow Chem. Co. v. United States, 476 U.S. 227 (1986).

219. *See* United States v. Knotts, 460 U.S. 276 (1983).

220. *See* United States v. Karo, 468 U.S. 705, 716 (1984):

> We cannot accept the Government's contention that it should be completely free from the constraints of the Fourth Amendment to determine by means of an electronic device, without a warrant and without probable cause or reasonable suspicion, whether a particular article—or a person, for that matter—is in an individual's home at a particular time. Indiscriminate monitoring of property that has been withdrawn from public view would present far too serious a threat to privacy interests in the home to escape entirely some sort of Fourth Amendment oversight.

221. *See* Florida v. Riley, 488 U.S. 445, 455 (1989) (O'Connor, J., concurring).

limited consent by using its assumption-of-risk approach. If one risks repetition or simultaneous transmission to the government of conversations that one supposes to be confidential, then surely one must also risk other types of confidante infidelity, including admitting government agents into areas otherwise private and in which the homeowner would not have welcomed them. Certainly there is a difference between bringing in a hidden transmitter and admitting a government agent; the question is whether the difference rises to a constitutional level for Fourth Amendment purposes and, if so, exactly why.

In *United States v. Matlock*,[222] the Court held that a person with common authority over private premises can admit the police and consent to a search, but clearly the informants in *On Lee*, *Hoffa*, and *White* were not in that category. The question is whether someone without common authority can similarly sanction a government intrusion, and the answer turns out to be yes and no. "Generally, a guest cannot give consent to a search of the premises that will be effective against his host."[223] In *Illinois v. Rodriguez*,[224] police gained entry to the defendant's apartment with the help of a person who had formerly shared the apartment and had retained a key to it. The Court upheld the state court's finding that the prosecution had failed to carry its burden of showing joint access or control so as to bring the case within the *Matlock* rule.[225] Nonetheless, the Court also held that the reasonable belief that there was authority, given the facts available to the police at the time, made the ensuing search reasonable for Fourth Amendment purposes.[226] That finding came with a significant limitation, however:

> [W]hat we hold today does not suggest that law enforcement officers may always accept a person's invitation to enter premises. Even when the invitation is accompanied by an explicit assertion that the person lives there, the surrounding circumstances could conceivably be such that a reasonable person would doubt its truth and not act upon it without further inquiry. As with other factual determinations bearing upon search and seizure, determination of consent to enter must "be judged against an objective standard: would the facts available to the officer at the moment . . . 'warrant a man of reasonable caution in the belief'" that the consenting party had authority over the premises? If not, then warrantless entry without further inquiry is unlawful unless authority actually exists.[227]

It seems clear, therefore, that for a casual visitor in a private place to admit the police would make evidence the police acquire during their presence

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222. 415 U.S. 164 (1974).

223. LAFAVE AL., *supra* note 2, § 3.10, at 259.

224. 497 U.S. 177 (1990).

225. *Id.* at 181-82 (finding "the Appellate Court's determination of no common authority over the apartment . . . obviously correct").

226. *Id.* at 186.

227. *Id.* at 188-89 (citation omitted) (quoting Terry v. Ohio, 392 U.S. 1, 21-22 (1968)).

inadmissible; the police would have no reason to think that such a person was authorized to give the consent necessary in the absence of a warrant or probable cause coupled with exigent circumstances rendering a warrant unnecessary.[228] A fortiori, for a casual visitor who is already a police informer (like Chin Poy in *On Lee*) to take advantage of his presence to admit officers without the host's knowledge or permission would similarly violate the Fourth Amendment. When an agent of the government effectively takes in not the officer herself, but rather only the officer's electronic ear, the government accomplishes precisely the same thing in terms of intercepting conversations as if the officer were in the closet or had trespassed for purposes of planting a listening device. To be sure, it is different simply to bring in a transmitter, but is it *constitutionally* different?

One can distinguish the two cases only by relying on theories of property and trespass that the Court has long since discarded for Fourth Amendment analysis.[229] If the Court really believes, as it continues to say, that the Fourth Amendment protects privacy, not property per se, then the cases are constitutionally indistinguishable, because the privacy of the individual with respect to his conversations is no more violated by the surreptitiously-admitted policeman in the closet than by the policeman's ear in the informer's pocket. Seizure of the conversation is the same in both instances, as is the defendant's decision to reveal the confidence to the informer and the risk the Court says he assumed in doing so.

All of this flows from the Court's all-or-nothing approach to expectations of privacy. Yet the Court's view blinks reality and ignores some of the Court's own precedents (and, one suspects, the Justices' own expectations)[230] that do recognize relative expectations of privacy. For example, in *Florida v. Jimeno*,[231] the Court noted that the expressed object of a search controls the inferred scope of consent if the defendant expresses no particular limitations on the search. In that case, the defendant consented to a search of his car for narcotics, and the Court held that this inferentially included opening a paper bag found on the floor of the car.[232] At the same time, the Court cited with approval a Florida case that held that consent to search a car's trunk did not reasonably include consent to break open locked containers found therein.[233] Similarly, permission for an undercover agent to enter the home is not consent to a search of the home,[234] and a call from a home for emergency help does not authorize a second entry for purposes of conducting

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228. There is a practical problem, however, of the extent to which the police must question someone who offers them access about his entitlement to do so.

229. *See, e.g.*, Rawlings v. Kentucky, 448 U.S. 98 (1980); Rakas v. Illinois, 439 U.S. 128 (1978); Katz v. United States, 389 U.S. 347 (1967).

230. *See infra* note 233 and accompanying text.

231. 500 U.S. 248 (1991).

232. *Id.* at 251-52.

233. *Id.* (citing State v. Wells, 539 So. 2d 464 (Fla. 1989), *aff'd*, 495 U.S. 1 (1990)).

234. *See* Gouled v. United States, 255 U.S. 298 (1921), *overruled in part by* Maryland Penitentiary v. Hayden, 387 U.S. 294 (1957).

a general search.[235] As a general rule, "[t]he scope of a consent search can be limited by the consentor [sic] to specific areas or types of items."[236]

Beyond even that, the Court has explicitly recognized a relative expectation of privacy in the Fourth Amendment context. In *Mancusi v. DeForte*,[237] police acting on a subpoena duces tecum (but not a warrant) invaded a union office used by DeForte and several other union officials and seized some union records from DeForte's possession. The Court held that DeForte had standing to object on Fourth Amendment grounds.

> [I]t seems clear that if DeForte had occupied a "private" office in the union headquarters, and union records had been seized from a desk or a filing cabinet in that office, he would have had standing. In such a "private" office, DeForte would have been entitled to expect that he would not be disturbed except by personal or business invitees, and that *records would not be taken except with his permission or that of his union superiors*. It seems to us that the situation was not fundamentally changed because DeForte shared an office with other union officers. DeForte still could reasonably have expected that only those persons and their personal or business agents would enter the office, and that records would not be touched *except with their permission or that of union higher-ups*.[238]

Here is an acknowledgment by the Court that one may have a reasonable expectation of privacy with respect to some persons and not others. DeForte clearly had no reasonable expectation of privacy with respect to his union superiors (and perhaps not even with respect to his colleagues who shared the office), but the majority had no trouble concluding that he nonetheless had such an expectation with respect to the government. The Court has reaffirmed this idea, even in the context of a government employee:

> Given the societal expectations of privacy in one's place of work expressed in both *Oliver* and *Mancusi*, we reject the contention made by the Solicitor General and petitioners that public employees can never have a reasonable expectation of privacy in their place of work. Individuals do not lose Fourth Amendment rights merely because they work for the government instead of a private employer. The operational realities of the workplace, however, may make *some* employees' expectations of privacy unreasonable when an intrusion is by a supervisor rather than a law enforcement official. Public employees' expectations of privacy in their offices, desks, and file cabinets, like similar expectations of employees in the private sector, may be reduced by virtue of actual office practices and procedures, or by legitimate

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235. *See* Thompson v. Louisiana, 469 U.S. 17 (1984).

236. WHITEBREAD & SLOBOGIN, *supra* note 127, § 12.05, at 290.

237. 392 U.S. 364 (1968).

238. *Id.* at 369 (emphasis added) (citations omitted).

> regulation. Indeed, in *Mancusi* itself, the Court suggested that the union employee did not have a reasonable expectation of privacy against his union supervisors.[239]

Thus, *Mancusi*'s recognition of a relative expectation of privacy appears to be more than a sport.

There are two other and more significant problems with the Court's position. An unspoken assumption underlies the false-friend cases. The Court implicitly states that an expectation of privacy is unreasonable for Fourth Amendment purposes if there is a risk of that expectation being frustrated. That is, *expectation* of privacy is not enough; there must be a *guarantee* of privacy. A moment's reflection will demonstrate why this assumption must remain unspoken for the Court's approach to retain even superficial validity. When a client speaks to her attorney, there is an expectation that the conversation will remain confidential. Indeed, the standards of professional conduct to which the attorney is subject demand confidentiality.[240] Nonetheless, there is a risk that the attorney will betray the client and turn incriminating information over to the police. If the attorney does so (at least without a prior agreement with the police), the client will be unable to suppress the evidence because the attorney acted as a private agent to whose conduct the Fourth Amendment does not apply.[241] When one spouse speaks to the other, there is an expectation of privacy as to the contents of the conversation, one that the law recognizes in the spousal privilege. Nonetheless, there is a risk that the hearing spouse will elect to relay the information to the government. Does that mean that the expectation of privacy that attended the conversation was unreasonable?

Certainly the Court itself does not operate that way. All of the Justices hire law clerks. They certainly expect their clerks jealously to guard the confidentiality of chambers.[242] There is always a risk, however, that a clerk will decide to reveal information about cases under consideration or other matters that transpire in chambers. For that matter, if a Justice had a stash of cocaine in a file drawer, a clerk might decide to reveal its existence, even if that risk is a remote one. Under the Court's rationale, the Justices' expectations of privacy with respect to their clerks are not reasonable, because in the Court's calculus, risk of perfidy equals unreasonableness. Why that should be is a mystery.

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239. O'Connor v. Ortega, 480 U.S. 709, 717 (1987).

240. *See, e.g.*, MODEL RULES OF PROF'L CONDUCT R. 1.6 (1983). The standards do not, however, cause the exclusion of improperly revealed material. "Even though the breach of those ethical confidentiality obligations might lead to professional discipline or loss of professional license, the professional codes do not provide a legal basis for the exclusion of evidence." PARK ET AL., *supra* note 167, § 8.02, at 418.

241. The client may, of course, have a civil action against the attorney, but she may have to pursue it from prison.

242. *See, e.g.*, David Lane, Bush v. Gore, *Vanity Fair, and a Supreme Court Law Clerk's Duty of Confidentiality*, 18 GEO. J. LEGAL ETHICS 863, 864 (2005) (noting that clerks must sign a confidentiality agreement when beginning Supreme Court employment).

Beneath the reasoning in the false-friend cases lies another assumption. The idea that a government intrusion carried out by deception is reasonable because of the suspect's consent is dependent upon the background premise that the Fourth Amendment protects only against searches known to be such by the suspect. That is, the false-friend cases seem to say that as long as the suspect does not know that a search is going on, there is no government intrusion and hence no Fourth Amendment problem. That assumes that the Fourth Amendment offers no protection against a search of which the suspect is unaware, but clearly that is not true. If it were, the government could conduct all the covert searches it wished, without concern about Fourth Amendment problems. *United States v. Payner*,[243] although refusing to suppress the seized evidence on standing grounds, nonetheless recognized that surreptitious, warrantless entry violates the Fourth Amendment. That holding demonstrates that the Amendment's focus is on the *fact* of government intrusion, not the *perception* of intrusion.

The false-friend cases rest on the idea that as long as the "consenting" suspect does not perceive a government intrusion, everything is all right. That reduces the idea of consent to a mockery and suggests that consent obtained by fraud is effective. As Professors Whitebread and Slobogin put it, "despite the Court's characterization of undercover encounters as consensual, these cases have nothing to do with consent as that concept is normally understood, since the nature of what is being agreed to is never made clear to the 'consentor [sic].'"[244] In other contexts, consent obtained by fraud or misrepresentation is ineffective.[245] This should not be surprising; otherwise giving consent unwittingly becomes the equivalent of issuing a blank check.

The Court should change its approach so that it more clearly reflects the values that underlie the Fourth Amendment. First, it should recognize relative expectations of privacy in this area as it has in others.[246] There is a critical difference between a person who decides after a conversation occurs to reveal its contents to the police and one who, cooperating with the police, engages the defendant in the conversation in the first place. In the first case, the individual is not acting as an agent of the police; in the second he is. If the false friend is acting as an agent of the police (and perhaps is wired to boot), there is official activity. The Fourth Amendment exists to guard individual privacy against official activity.

The Court recognized this distinction decades ago, when the exclusionary rule applied to the federal government because of *Weeks* but did not yet apply to

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243. 447 U.S. 727 (1980); *see supra* notes 116-21 and accompanying text.

244. WHITEBREAD & SLOBOGIN, *supra* note 127, § 12.01, at 276.

245. *See, e.g.*, RESTATEMENT (SECOND) OF TORTS § 892B(2) (1979):

> If the person consenting to the conduct of another is induced to consent by a substantial mistake concerning the nature of the invasion of his interests or the extent of the harm to be expected from it and the mistake is known to the other or is induced by the other's misrepresentation, the consent is not effective for the unexpected invasion or harm.

246. *See supra* notes 235-39 and accompanying text.

the states. In *Byars v. United States*,[247] the defendant challenged the admissibility of evidence discovered when a federal agent participated in a search conducted by state police under a state-issued warrant that the Supreme Court declared could not constitutionally authorize a federal search.[248] The government also argued that since the state officers had found some of the evidence and turned it over to the federal officer, that evidence was not tainted. However, a unanimous Court refused to permit the government to evade the constitutional principle.

> We do not question the right of the federal government to avail itself of evidence improperly seized by state officers operating entirely upon their own account. But the rule is otherwise when the federal government itself, through its agents acting as such, participates in the wrongful search and seizure. To hold the contrary would be to disregard the plain spirit and purpose of the constitutional prohibitions intended to secure the people against unauthorized official action. The Fourth Amendment was adopted in view of long misuse of power in the matter of searches and seizures both in England and the colonies; and the assurance against any revival of it, so carefully embodied in fundamental law, is not to be impaired by judicial sanction of equivocal methods, which, regarded superficially, may seem to escape the challenge of illegality but which, in reality, strike at the substance of the constitutional right.[249]

The same principled reasoning applies when the source of the evidence is a false friend acting in cooperation with the government. If a private individual acting on his own account elects to turn evidence over to the government for use against a defendant, there is no Fourth Amendment violation, even if the individual obtained the evidence as the result of an unreasonable search.[250] This is not the case if the individual is already acting as a government agent.[251]

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247. 273 U.S. 28 (1927).

248. *Id.* at 29.

249. *Id.* at 33-34.

250. Coolidge v. New Hampshire, 403 U.S. 443, 487 (1971); Burdeau v. McDowell, 256 U.S. 465, 475 (1921). *See generally* WHITEBREAD & SLOBOGIN, *supra* note 127, § 4.02, at 105.

251. The year before the Court decided *Mapp v. Ohio*, 367 U.S. 643 (1961), a narrow majority of the Justices went even further, holding that evidence obtained by an unreasonable search and seizure is inadmissible in federal proceedings even if the state officers were acting entirely on their own. Elkins v. United States, 364 U.S. 206 (1960). The Court thus laid to rest what had come to be called the silver platter doctrine, concluding that "this doctrine can no longer be accepted." *Id.* at 208. As Justice Stewart pointed out, the doctrine actually originated in *Weeks*, which held that admission, against *Weeks*, of evidence that state officers had seized unlawfully (but without federal participation or connivance) was not constitutional error. *Id.* at 211. *Byars* had confirmed this view while holding that if a federal officer participated in the search "under color of his federal office" the resulting evidence was inadmissible. *Byars*, 273 U.S. at 33; *see also* Gambino v. United States, 275 U.S. 310 (1927) (finding when state officers conducted a search only to gather evidence of a federal crime, the search was on behalf of the United States, producing only inadmissible evidence).

In *United States v. White*,[252] the plurality suggested that it was of no moment whether the private individual was already a police agent at the time she acquired the evidence from the defendant or decided afterward to become one.[253] Yet, surely that cannot be. Status matters very much in the law of search and seizure. If a private citizen acting entirely on his own conducts an unreasonable search and turns the product over to the police, the evidence is admissible even though the police could not have conducted the search themselves. If the citizen subsequently becomes a police officer, that does not retroactively make the search unconstitutional. By the same token, if a police officer conducts a search that violates the Fourth Amendment, the evidence she seizes does not become admissible because the officer happens to retire the following day. Furthermore, if the distinction were unimportant, one would not expect to see the circuit courts wrestling with the question of when a non-officer is acting as an agent of the government; yet they do.[254]

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252. 401 U.S. 745 (1971).

253. *Id.* at 752 (emphasis added) ("If the law gives no protection to the wrongdoer whose trusted accomplice *is or becomes a police agent*, neither should it protect him when that same agent has recorded or transmitted the conversations which [sic] are later offered in evidence to prove the State's case.").

254. The circuit courts have struggled trying to determine when a private citizen is a government agent for Fourth Amendment purposes. They appear to consider two criteria: (1) whether the government knew of and acquiesced in the private search; and (2) whether the citizen acted to assist law enforcement or acted for his own purposes. *See, e.g.*, United States v. Ellyson, 326 F.3d 522, 527 (4th Cir. 2003); United States v. Souza, 223 F.3d 1197, 1201 (10th Cir. 2000). Whether an agency relationship exists depends on the degree of government participation in the citizen's activities. *See* United States v. Jarrett, 338 F.3d 339, 344 (4th Cir. 2003). Mere passive acceptance by the government is not enough. *Ellyson*, 326 F.3d at 546. Several circuits have also ruled that the citizen's sole objective must be to assist law enforcement. *See* United States v. Smith, 383 F.3d 700, 705 (8th Cir. 2004); *Ellyson*, 326 F.3d at 528; United States v. Shahid, 117 F.3d 322, 326 (7th Cir. 1997).

> A private citizen might decide to aid in the control and prevention of criminal activity out of his or her own moral conviction, concern for his or her employer's public image or profitability, or even the desire to incarcerate criminals, but even if such private purpose should happen to coincide with the purposes of the government, "this happy coincidence does not make a private actor an arm of the government."

*Shahid*, 117 F.3d at 326 (quoting United States v. Koenig, 856 F.2d 843, 850-51 (7th Cir. 1988)). It is not obvious why the motive of the individual should be relevant; certainly under the law of agency it is not. The question is *whether* the individual acts for the principal, not *why* she does. *See* RESTATEMENT (SECOND) OF AGENCY § 277 & cmt. d (1957) (holding principal liable for agent's misrepresentation within scope of duty even if agent misrepresents from motive other than serving principal); *id.* § 262 cmt. a, illus. 1, 2 (1957) (holding principal liable for agent's misrepresentations within scope of duty even if agent acts "entirely for his own purposes" unless person to whom the representation is made has notice). In any event, a false friend who seizes tangible or intangible evidence for the government after the government has sent him (and perhaps wired him) is acting on the government's behalf. That he may derive personal satisfaction, an increased sense of

*Massiah v. United States*[255] offers an analogous example of the importance of the listener's status. It, too, is a false-friend case, though it deals with the Sixth Amendment rather than the Fourth.[256] After the district court granted Massiah release on bail in a federal narcotics case, his co-defendant permitted the government to install a listening device in the co-defendant's car. He then engaged Massiah in conversation about the case. Agent Murphy testified at Massiah's trial as to the contents of the automobile conversation. The Court found that the government's conduct had violated Massiah's Sixth Amendment right to the effective assistance of counsel.[257] Justice Stewart's opinion quoted Judge Hays's opinion from the Second Circuit:[258] "In this case, Massiah was more seriously imposed upon [than the defendant in a police-station-interrogation case] because he did not even know that he was under interrogation by a government agent."[259] Had the co-defendant not been cooperating with the government when Massiah made the incriminating statements, and had he subsequently decided to turn the statements over to the government, it would have dictated a different outcome because there would have been no governmental action.[260] The Court reversed the conviction and remanded the case

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security, or some other personal benefit from doing so is beside the point. After all, most agents act for their principals for reasons other than unadulterated altruism; they do so because they expect to reap some benefit (often salary or professional fees) as a result.

255. 377 U.S. 201 (1964).

256. Massiah also argued that there was a Fourth Amendment violation in the government's use of the listening device. In light of its holding on the Sixth Amendment argument, the Court declined to reach that issue. *Id.* at 204.

257. *Id.* at 206.

258. United States v. Massiah, 307 F.2d 62 (2d Cir. 1962), *rev'd*, 377 U.S. 201 (1964). There were multiple charges against Massiah, one for conspiracy to import drugs and several for related substantive offenses. The Circuit panel split. Chief Judge Lumbard and Judge Waterman ruled that the government's behavior did not violate Massiah's rights; Judge Hays dissented on that point. Judges Hays and Waterman ruled that the trial court's charge to the jury on the conspiracy count was improper. As a result, the court affirmed Massiah's conviction on the substantive counts of the indictment but reversed on the conspiracy count.

259. *Massiah*, 377 U.S. at 206 (quoting *Massiah*, 307 F.2d at 72-73 (Hays, J., concurring in part and dissenting in part)).

260. *See id.* at 207 ("All that we hold is that the defendant's . . . incriminating statements, *obtained by federal agents* under the circumstances here disclosed, could not constitutionally be used by the prosecution as evidence against him at trial." (emphasis added)). Justice White's dissent emphasized the difference.

> Had there been no prior arrangements between Colson [the co-defendant] and the police, had Colson simply gone to the police after the conversation had occurred, his testimony relating to Massiah's statements would be readily admissible at the trial, as would a recording which [sic] he might have made of the conversation. In such event, it would simply be said that Massiah risked talking to a friend who decided to disclose what he knew of Massiah's criminal activities. But if, as occurred here, Colson had been cooperating with the police prior to his meeting with Massiah, both his evidence

for a new trial without the tainted evidence.[261]

As *Massiah* makes clear, status is everything. There was no claim in *Massiah* that the defendant's revelations were anything but consensual. The co-defendant did not trick Massiah into saying anything he did not intend to say. The government simply sent the co-defendant to engage Massiah in conversation about the case. It is superficially tempting to distinguish *Massiah* from the false-friend cases because the Court ruled under the Sixth Amendment, not the Fourth. That, however, overlooks the critical aspect common to both situations. In both situations, the government intruded on a privacy status that the Constitution recognizes. In both situations, the defendants willingly (albeit unknowingly) reveal evidence the government seeks. The privacy status between defendant and attorney stems from the Sixth Amendment's guarantee of the assistance of counsel. The privacy status of the defendant with respect to his home, office, or activities conducted out of public view comes from the Fourth Amendment.

Notably missing from the majority opinion in *Massiah* is any mention of Massiah's revelations being consensual. It made no difference at all. Justice White's dissent did focus on the voluntariness of Massiah's statements,[262] which did nothing so much as emphasize the majority's view that voluntariness was irrelevant and that the important fact was government intrusion. The question remains why the Court, in the Fourth Amendment area, chooses to focus on voluntariness rather than the fact that a government-sponsored intrusion occurs. Perhaps there is an unspoken hierarchy of amendments in the Court's calculus, with the Sixth Amendment right to counsel being more important than the Fourth Amendment's right to privacy. If so, the Court has never indicated such, nor is there any principled basis that it could articulate for making importance distinctions among provisions of the Constitution.

The critical thing to recognize is that when the government uses an individual to acquire evidence from a suspect, and the evidence is not in public view, a governmental intrusion—a search—occurs.[263] However, where the government uses a private actor to gather evidence that the government could not obtain on its own, it seeks to evade the Fourth Amendment's requirements. The Supreme Court should recognize such activity for what it is and, rather than permitting or even tacitly encouraging it, take steps to bring such conduct within Fourth Amendment scrutiny.

That is not to say that the government can no longer use undercover agents or rely on informers or false friends; it certainly can. Use of such individuals may

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> and the recorded conversation are somehow transformed into inadmissible evidence despite the fact that the hazard to Massiah remains precisely the same—defection of a confederate in crime.

*Id.* at 211 (White, J., dissenting).

261. *Id.* at 207 (majority opinion).

262. *See id.* at 211 (White, J., dissenting).

263. If the evidence is in plain view, of course, the government need not resort to a private individual; it can make its observations directly. *See generally* LAFAVE ET AL., *supra* note 2, § 3.2(b), at 130-33.

represent good police work. The point is, however, that it *is* police work. The activities that such persons conduct are searches and are, therefore, subject to Fourth Amendment analysis and protections. The police search conducted through a wired false-friend is no less a search than if the police planted the listening device themselves. If the police wish to plant a listening device in a suspect's home or office, that activity will be subject to Fourth Amendment standards, which is to say that it would require a warrant supported by probable cause. When the police instead send a recording device into the home or office on the person of the false friend, the fact that the false friend transports the device for the police should make no constitutional difference.

## CONCLUSION

The Court's false-friend jurisprudence connotes a society in which one always speaks at his own peril, for according to the Court, no expectation of privacy is reasonable if there is a chance that it will be frustrated. Revealing something in conversation risks that the listener is not simply the person whom the speaker believes he is addressing, but also the government. It is not just the wrongdoer who need be concerned. As Justice Harlan pointed out, the perception that conversation may not be truly private will have a general deterrent effect.[264] Political discussion may become more restrained, and people may hesitate openly to discuss controversial social issues. The time in which we live only accentuates that possibility. As a part of its response to terrorism, the federal government has vigorously asserted the entitlement to arrest and confine incommunicado, indefinitely, and without judicial process of any sort anyone whom it designates an "enemy combatant," whether citizen or alien. It finally took the Supreme Court to tell the government that it could not dispense with all legal process and imprison someone merely on the executive branch's say-so.[265] It is not much of a stretch to imagine that in such a climate, people might be extraordinarily cautious discussing the Middle East if they thought the government were listening.

Speaking also becomes riskier for the innocent person suspected of a crime. Comments taken out of context (or, for that matter, in context) may help the government build a circumstantial case. For example, the innocent suspect may reveal to someone that he was in the vicinity of the crime scene or that he harbors a grudge against the victim of a crime. Opportunity and motive being relevant to proof of guilt, the suspect may thus help unwittingly to incriminate himself, though he has done nothing wrong.

Justice Harlan's dissent in *United States v. White*[266] warned against unsupervised use of government power to spy on the people. He urged that

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264. *See supra* text accompanying note 175.

265. *See, e.g.*, Hamdi v. Rumsfeld, 542 U.S. 507 (2004); Rasul v. Bush, 542 U.S. 466 (2004); Rumsfeld v. Padilla, 542 U.S. 426 (2004).

266. 401 U.S. 745, 768-95 (1971) (Harlan, J., dissenting); *see supra* text accompanying note 175.

electronic and false-friend surveillance as seen in the cases from *On Lee* to *White* be permitted only under the warrant requirements of the Fourth Amendment, so that government intrusion is possible only if a magistrate agrees with the government that there is probable cause.[267] Respect for the principles that underlie the Fourth Amendment and the rebellion that produced it, demands no less.

Daniel Webster warned of the sort of danger posed by unaccountable executive power.

> Good intentions will always be pleaded for every assumption of power, but they cannot justify it, even if we were sure they existed. . . . [T]he Constitution was made to guard the people against the dangers of good intentions, real or pretended. There are men, in all ages, who mean to govern well; but they mean to govern. They promise to be good masters; but they mean to be masters.[268]

The government always argues its good intentions for spying on the people, whether it is to apprehend criminals, as Justice White argued in *White*, or to prevent terrorism. One need not question the government's good intentions to appreciate that much of the Bill of Rights exists precisely to guard against well-intentioned zeal, more than outright knavery. That is why Justice Douglas warned that:

> We are rapidly entering the age of no privacy, where everyone is open to surveillance at all times; where there are no secrets from government. The aggressive breaches of privacy by the Government increase by geometric proportions. Wiretapping and "bugging" run rampant, *without effective judicial or legislative control.*
>
> . . . .
>
> [T]he privacy and dignity of our citizens is being whittled away by sometimes imperceptible steps. Taken individually, each step may be of little consequence. But when viewed as a whole, there begins to emerge a society quite unlike any we have seen—a society in which government may intrude into the secret regions of a man's life at will.[269]

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267. *See id.* at 786-87.

268. Daniel Webster, United States Senator, Address at a Reception at New York, March 15, 1837, *in* 2 THE PAPERS OF DANIEL WEBSTER: SPEECHES AND FORMAL WRITINGS 132 (Charles M. Wiltse, ed. 1988).

269. Osborn v. United States, 385 U.S. 323, 341, 343 (1966) (Douglas, J., dissenting) (emphasis added). As Justice Douglas said on another occasion, "[T]he Constitution was designed to keep government off the backs of the people." WILLIAM O. DOUGLAS, POINTS OF REBELLION 6 (1969); *see also* Laurence Tribe, *Seven Deadly Sins of Straining the Constitution Through a Pseudo-Scientific Sieve*, 36 HASTINGS L.J. 155, 162 (1984) (footnote omitted):

> [The Court invites] "the tyranny of small decisions," a lovely phrase coined some time ago by the economist Alfred Kahn. He used the phrase to describe the fallacies of those economists and managers who tend to look down at their feet to figure out how far

The Supreme Court's false-friend jurisprudence has written a prescription for exactly the types of harm that Justice Douglas foresaw. By declaring that one has no reasonable expectation of privacy when speaking with another, the Court removes conversation from the protections of the Fourth Amendment, leaving government power unchecked. The Amendment becomes an empty, and mocking, promise. The Court has thus abdicated the judicial function in an area so sensitive that it lay at the heart of the revolution.

The nation ratified the Fourth Amendment (and the First and Fifth as well) to protect against excessive governmental intrusion. The effect of the disappearance of the reasonable expectation of privacy is that Fourth Amendment limits—and, indeed, the Fourth Amendment itself as a practical matter—cease to exist with respect to communications. What the Court has accomplished (without, of course, saying so) is a return to *Olmstead*'s idea that words are not within the Fourth Amendment's protection.[270] In other words, it has used *Katz*'s rationale de facto to overrule one of the central holdings of *Katz*. Under the Court's assumption-of-risk and reasonable-expectation-of-privacy approach, one's legally protected expectation of privacy vanishes whenever one communicates with another person, because one never knows when the government may be listening. The Court's logic requires every person to *assume* that the government is listening, without having a warrant, without probable cause, and without reasonable suspicion. The President's NSA spying program confirms the soundness of that assumption. George Orwell would be proud.[271] Those who proposed, wrote and ratified the Fourth Amendment, however, might be a bit concerned. Perhaps we should be as well.

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they've gone and where they're heading. It's not a very illuminating view. They may think they've taken but a short step from where they were just a moment ago; it's no surprise that, by the time they realize it; they've departed a remarkable distance from their first premises.

270. *See supra* notes 51-64 and accompanying text.

271. *See* GEORGE ORWELL, NINETEEN EIGHTY-FOUR (1949).

# WILL MORE SUNLIGHT FADE THE PINK SHEETS? INCREASING PUBLIC INFORMATION ABOUT NON-REPORTING ISSUERS WITH QUOTED SECURITIES

MICHAEL K. MOLITOR*

*Publicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants; electric light the most efficient policeman.*[1]

## INTRODUCTION

The Sarbanes-Oxley Act of 2002 ("SOX")[2] contains a wealth of provisions designed to prevent a repetition of the many real and perceived corporate abuses of the late 1990s such as the Enron scandal. Many companies, particularly publicly traded companies subject to the Securities Exchange Act of 1934 ("Exchange Act"),[3] were required after SOX to implement what seemed like an endless array of new compliance programs and to follow an extremely complex set of new rules.[4] Around the same time, the country's securities markets, including the New York Stock Exchange ("NYSE") and The NASDAQ® Stock Market ("NASDAQ"), significantly toughened their corporate governance rules.[5] Few would disagree that the stated purpose of these developments was to restore investor confidence in the nation's securities markets.[6] Investors, Congress hoped, would now feel that they could better trust the available information concerning public companies or that there would at least be serious criminal and civil penalties for companies and insiders who engaged in fraud or otherwise disseminated false or misleading information.

It seems, however, that SOX and related Securities and Exchange Commission ("Commission") rulemaking led to unintended effects for many

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* Assistant Professor of Law, Thomas M. Cooley Law School. B.A., 1991, University of Michigan, 1991; J.D., *cum laude*, 1994, Wayne State University Law School. The author wishes to thank his former colleague Hugh Makens and his current colleague Ronald Trosty for their helpful comments on an earlier draft of this Article.

1. LOUIS D. BRANDEIS, OTHER PEOPLE'S MONEY 92 (Frederick A. Stokes Co. 1913).

2. Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified as amended in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

3. 15 U.S.C. §§ 78a-78nn (2000).

4. *See infra* notes 54-91 and accompanying text.

5. *See infra* notes 138-43 and accompanying text.

6. As the Securities and Exchange Commission stated: "The strength of the U.S. financial markets depends on investor confidence. Recent events involving allegations of misdeeds by corporate executives, independent auditors and other market participants have undermined that confidence." Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, Securities Act Release No. 33-8177, Exchange Act Release No. 34-47235, 68 Fed. Reg. 5,110 (Jan. 31, 2003) (to be codified at 17 C.F.R. pts. 228, 229, and 249) (footnotes omitted). Of course, commentators were quick to point out many flaws in SOX. *See generally* Joseph F. Morrissey, *Catching the Culprits: Is Sarbanes-Oxley Enough?*, 2003 COLUM. BUS. L. REV. 801.

companies. Instead of increasing the quantity and quality of the information that these companies provide to their investors, it drove them out of the public markets. During the two years following SOX, at least 158 companies that were reporting companies under the Exchange Act voluntarily went private.[7] The owners of these companies now find themselves in the position of having far less information about their investments available to them than before SOX.[8]

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7. Andrew Ross Sorkin, *Kissing the Public Goodbye*, N.Y. TIMES, Aug. 8, 2004, § 3, at 34 ("According to Thomson First Call, in the first year after [SOX] was approved, 99 companies were taken private. In the second year, the number was only 59."). Another study, using the filing of a Schedule 13E-3, as the criterion for going private, found that 142 companies went private during the eighteen months following SOX, compared to ninety-three in the nineteen months before SOX was enacted. ELLEN ENGEL ET AL., THE SARBANES-OXLEY ACT AND FIRMS' GOING-PRIVATE DECISIONS 12 (2004), http://ssrn.com/abstract=546626; *see* 17 C.F.R. § 240.13e-100 (2004). The study found data that was "consistent with the notion that SOX is associated with an increase in the number of firms electing to go private" despite prevailing "market conditions [that] would appear to provide an attractive reason for firms to stay public in the post-SOX period." ENGEL ET AL., *supra*, at 12. Although the following figures are not precisely on point, according to the Commission:

> In 2002, there were a total of 862 delistings [from securities exchanges], with the Commission receiving 474 Forms 25, 266 delisting applications from exchanges, and 62 *voluntary* delisting applications from issuers. In 2003, the Commission received a total of 799 delistings, which included 547 Forms 25, 190 delisting applications from exchanges, and 57 *voluntary* delisting applications from issuers.

Removal from Listing and Registration of Securities Pursuant to Section 12(d) of the Securities Exchange Act of 1934, Exchange Act Release No. 34-49858, 69 Fed. Reg. 34,860, 34,861 (June 22, 2004) (to be codified at 17 C.F.R. pts. 232, 240, 249) (emphasis added). *See generally* MARC MORGENSTERN & PETER NEALIS, GOING PRIVATE: A REASONED RESPONSE TO SARBANES-OXLEY? 1 n.3 (2004), http://www.sec.gov/info/smallbus/pnealis.pdf ("Some empirical data suggests that the frequency of going-private transactions has increased following the passage of Sarbanes-Oxley." (citations omitted)).

8. Companies routinely went private for many reasons before SOX was enacted and many will do so in the future for reasons unrelated to SOX. However, the many requirements of SOX, particularly the internal controls report contemplated by Section 404, have substantially increased the costs of being public. Because these costs continue to be incurred year after year, some companies may opt out of being public.

For example, a survey conducted by the law firm Foley & Lardner asked: "As a result of the new corporate governance and public disclosure reforms implemented since the enactment of the Sarbanes-Oxley Act in 2002, is your company considering [going private]?" In 2003, thirteen percent of the companies that responded to the survey answered yes. In 2004, the number was twenty-one percent. In 2005, the number was twenty percent. THOMAS E. HARTMAN, THE COST OF BEING PUBLIC IN THE ERA OF SARBANES-OXLEY 10 (2005), http://www.foley.com/files/tbl_s31Publications/FileUpload137/2777/2005%20cost%20of%20Being%20Public%20Final.pdf.

Professor William J. Carney of the Emory Law School recently completed a study of the costs of securities regulation for smaller public companies. According to a summary of his study, which was included in written comments, dated June 17, 2005, that Professor Carney provided to the

SOX came shortly after the 1999 National Association of Securities Dealers, Inc. ("NASD") "eligibility rule," which required most issuers with securities quoted on the OTC Bulletin Board ("OTCBB") to be Exchange Act reporting companies and attempted to reduce fraud and manipulation in that market.[9] However, this requirement swept potential fraud and manipulation under the rug because most of the over 3000 companies that were delisted from the OTCBB—along with many of the companies that have gone private after SOX—now have their securities quoted on the Pink Sheets, which is a largely unregulated market. The Pink Sheets, which does not require that companies be Exchange Act reporters or meet any quantitative or qualitative requirements to have their securities quoted, has recently seen a massive increase in its market "population."[10]

Information about issuers quoted on the Pink Sheets is often difficult to find because only a bare minimum of information about non-Exchange Act reporting companies must be available to investors. Further, the information that is provided is difficult to retrieve. Thus, the information rarely reaches the investor before the investment is made.[11] Still, the Pink Sheets recently took a significant step toward addressing this problem by adopting a new disclosure policy and threatening to discontinue displaying quotations for the securities of issuers that do not comply with it. The Pink Sheets should be commended for this very important step, particularly since the Pink Sheets market has long been filled with issuers about which no significant information is publicly available and previous attempts by the Commission to strengthen disclosure requirements have

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Commission's Advisory Committee on Smaller Public Companies, of the 114 companies that filed a Schedule 13E-3 during 2004, forty-four (39%) "not only listed high compliance costs as a reason for terminating registration" under the Exchange Act, but also included estimates of those costs. William J. Carney, Remarks to SEC Advisory Committee on Smaller Public Companies 2 (June 17, 2005), *available at* http://www.sec.gov/rules/other/265-23/wjcarney061705.pdf. Some of the other Schedule 13E-3 filers also mentioned increased compliance costs. An interesting aspect of this study is that these firms tended to be small public companies, with median gross revenues of $25 million. Professor Carney observed: "Are investors and would-be investors in these companies better off as a result of SOX? I find it impossible to conclude that they are." *Id.* at 5.

9. *See infra* notes 144-48 and accompanying text.

10. *See infra* notes 146-47 and accompanying text.

11. Although not all Pink Sheets securities are "microcap" stocks, the Commission has observed:

> The biggest difference between a microcap stock and other stocks is the amount of reliable, publicly available information about the company. Larger public companies file reports with the SEC that any investor can get for free from the SEC's website. Professional stock analysts regularly research and write about larger public companies . . . . In contrast, information about microcap companies can be extremely difficult to find, making them more vulnerable to investment fraud schemes.

U.S. Securities and Exchange Commission, Microcap Stock: A Guide for Investors (Aug. 2004), http://www.sec.gov/investor/pubs/microcapstock.htm [hereinafter Microcap Stock].

stalled.[12] However, this Article argues that the Pink Sheets' disclosure policy contains serious flaws, both in terms of which issuers it covers and what information it requires.

The big question, discussed in Part III of this Article, is how best to improve the quantity and quality of information available about non-reporting Pink Sheets issuers that voluntarily have entered the market. The goal should be to provide sufficient information without imposing unreasonable requirements on these issuers or unduly hindering the operation of markets like the Pink Sheets;[13] as such, this Article does not argue that full Exchange Act reporting status should be required of such issuers. However, because one of the primary goals of the securities laws is to ensure that investors have access to important information about their investments and because increasing the amount and quality of information available to investors may help reduce fraud and benefit investors (not to mention the issuers themselves), Part III offers several suggestions toward a workable solution, including required periodic disclosures for Pink Sheets issuers. Part III also discusses ways to implement the Commission's long-stated desire to establish a repository of Exchange Act Rule 15c2-11 information and make it easily accessible to investors without overburdening issuers or broker-dealers. It also examines the regulatory basis upon which such requirements could be established and suggests a standardized warning that should be given to all investors in non-reporting Pink Sheets issuers to alert them to the many differences between such issuers and those that are fully subject to the requirements of the Exchange Act.

Before turning to these issues, this Article discusses important background material. Part I provides an overview of the extensive regulation to which public companies are subject and describes the requirements for an issuer's securities to be traded on a securities market. Part II briefly discusses how painless it can be for a public company to "go dark" and terminate its reporting obligations under the Exchange Act. These discussions provide a starting point to consider whether, and to what extent, current regulations should be changed.

## I. OVERVIEW OF DISCLOSURE REQUIREMENTS AND THE PUBLIC SECURITIES MARKETS

The relationship between a corporation[14] and its shareholders is primarily a matter of state law. As such, state law ordinarily will determine what

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12. *See infra* notes 318-47 and accompanying text.

13. Although this Article focuses on the Pink Sheets, the reader should understand that other markets may arise in the future that function similarly; the concerns expressed in this Article about the scarcity of available information would also apply to such markets.

14. To avoid unneeded complexity, this Article is written as if all public companies are corporations. Obviously, this is not the case; many different types of business entities can have publicly traded securities. The reader should also be aware that this Article focuses on domestic issuers. The requirements for foreign issuers whose securities are traded in the United States are different in many significant respects.

information a corporation must provide to its shareholders.[15] However, if the corporation is subject to the reporting requirements of the Exchange Act, the amount of information that it must provide to its shareholders and the Commission dramatically increases. Before examining those requirements, however, we will examine when registration under the Exchange Act is required. Interestingly, not all companies whose securities are traded by the public must be Exchange Act registrants.

### *A. Exchange Act Registration Requirements*

There are three ways in which a company (the issuer) can be required to be "public" (i.e., subject to the reporting requirements of the Exchange Act): (1) registration under Section 12(b) of the Exchange Act,[16] which is required when

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15. The laws of most states require that corporations provide certain information to their shareholders. For example, the Model Business Corporation Act provides that shareholders are entitled to inspect and copy records such as the corporation's articles of incorporation, bylaws, board resolutions relating to shares, and minutes of shareholder meetings. MODEL BUS. CORP. ACT § 16.02(b) (1984). In addition, shareholders may inspect and copy other information, such as board and committee meeting minutes and accounting records, if the shareholder makes a demand for inspection in "good faith and for a proper purpose" and the records are "directly connected with his purpose." *Id.* § 16.02(c). Further, the corporation must mail its annual financial statements to shareholders within 120 days after the end of its fiscal year and file a brief annual report with the secretary of state, which shareholders are entitled to inspect under section 16.01(e), with or without a "proper purpose." *Id.* §§ 16.20-.21. Finally, corporations must notify shareholders of the date, time and place of shareholders' meetings or if action is to be taken by written consent without a meeting. *Id.* §§ 7.04-.05. Although these information requirements will vary, perhaps quite widely, from state to state, they are not particularly expansive. The shareholder who takes no steps to request information from the corporation will receive only annual financial statements and notices of shareholder meetings, if any are held (and oftentimes they are not). A minority shareholder who has no relationship to management that would allow greater access or more frequent information thus will not have much current information about his investment, unless the corporation voluntarily adopts a more liberal disclosure policy.

16. 15 U.S.C. § 78*l*(b) (2000). Together with Section 12(a), Section 12(b) requires registration when an issuer lists a class of its securities on a national securities exchange. NASDAQ, being completely electronic and lacking a trading floor or auction environment, currently is not an exchange, although its application to become an exchange was approved in January 2006. The Nasdaq Stock Market, Inc., Notice of Filing of Application for Registration as a National Securities Exchange Under Section 6 of the Securities Exchange Act of 1934, Exchange Act Release No. 34-44396, 66 Fed. Reg. 31,952 (June 13, 2001); In the Matter of the Application of The Nasdaq Stock Market, Inc. for Registration as a National Securities Exchange, Exchange Act Release No. 34-53128, 71 Fed. Reg. 3550 (Jan. 23, 2006). The Commission's order approving the application of The Nasdaq Stock Market LLC to register as an exchange was conditioned on the satisfaction of certain conditions.

To list its securities, the issuer must comply with the exchange's requirements, which typically concern the issuer's size, financial condition, compliance with corporate governance requirements,

an issuer lists a class of its securities on a national securities exchange such as NYSE; (2) registration under Section 12(g),[17] which is usually required when the issuer has 500 or more record holders of a class of its equity securities; or (3) by falling under Section 15(d),[18] which subjects an issuer to Exchange Act reporting requirements for some time following the effectiveness of a registration statement for a securities offering under the Securities Act of 1933.[19] Although Sections 12(b) and 15(d) are relatively self-explanatory, Section 12(g) is much trickier.

Section 12(g), along with Exchange Act Rule 12g-1,[20] requires that any issuer engaged in interstate commerce, in a business affecting interstate commerce (obviously easy tests to meet), or whose securities are traded through the mails or instrumentalities of interstate commerce and that has more than $10 million in assets and 500 or more holders of record of a class[21] of equity securities must register that class.[22] Whether an issuer must register a class of equity securities

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and other matters. *See infra* notes 130-43 and accompanying text. Section 12(b) does not require that an issuer have any specific number of security holders. As a practical matter, however, the exchanges require a minimum level of public ownership to ensure an active trading market. For example, NYSE generally requires that a domestic issuer have at least 2000 shareholders that each own at least 100 shares. *See* NYSE, Inc., Listed Company Manual § 102.01(A) (2005), *available at* http://www.nyse.com/audience/listedcompanies.html (follow "Listed Company Manual" hyperlink) (last visited Jan. 4, 2006) [hereinafter NYSE Listed Company Manual]; *see also infra* note 130 and accompanying text.

17. 15 U.S.C. § 78*l*(g).

18. 15 U.S.C. § 78o(d) (2000). Under Section 15(d), an issuer that has filed a registration statement under the Securities Act of 1933 that became effective is subject to the periodic reporting requirements of the Exchange Act regardless of the number of its security holders (subject to a few exceptions). *Id.* Unless the issuer is independently required to register its securities under Section 12(b) or Section 12(g), however, it will not be a "full" public company. For example, it will not be subject to the proxy rules under Section 14 and its shareholders will not be subject to Section 16 of the Exchange Act, both of which apply only to securities that are registered pursuant to Section 12. *See* 15 U.S.C. §§ 78n, 78p (2000). Section 15(d) reporting requirements are automatically suspended as to any fiscal year (other than the fiscal year in which the Securities Act registration statement became effective) if, at the beginning of that fiscal year, there are fewer than 300 security holders of record of each class of securities as to which the Securities Act registration statement related. 15 U.S.C. § 78o(d).

19. 15 U.S.C. §§ 77a-77aa (2000). A class of securities will only be considered registered under one of these sections at any given point in time. For example, even if a class of securities is required to be registered under Section 12(g), its registration under that section is automatically suspended while it is registered under Section 12(b).

20. 17 C.F.R. § 240.12g-1 (2005).

21. Section 12(g)(5) broadly defines a "class" of stock as including all securities with "substantially similar character" and whose holders have "substantially similar rights and privileges." 15 U.S.C. § 78*l*(g)(5). Thus, an issuer cannot artificially divide a class of stock into two or more classes and validly claim that each is a separate "class."

22. Section 12(g)(2) excludes some types of securities from this requirement, including

under Section 12(g) is determined at the end of its fiscal year. If the issuer then meets the requirements of Section 12(g), it must register the class within 120 days.

The 500-record holder threshold for registration may raise several issues. Rule 12g5-1(a) provides that securities are "'held of record' by each person who is identified as the owner of such securities on records of security holders maintained by or on behalf of the issuer."[23] In an attempt to address common problems with company records, subsection (a)(1) of the rule further provides that if shareholder records have not been maintained in accordance with accepted practice, any additional person who would be identified as a holder of record if the records were properly maintained will be counted.[24] Also, Instruction 3 to the rule provides that if the issuer "knows or has reason to know that the form of holding securities of record is used primarily to circumvent the provisions of section 12(g) or 15(d) of the [Exchange] Act, the beneficial owners of such securities shall be deemed to be the record owners thereof."[25]

For a corporation that is first becoming subject to Section 12(g), determining the number of record shareholders is usually relatively easy. For a corporation that is already public, however, determining the number of record shareholders is more difficult because it will likely have many "street name" or "beneficial" shareholders. These shareholders do not have physical stock certificates; instead, they own stock through a bank or broker-dealer, which in turn holds a position in a stock certificate for a large number of shares, which certificate is issued in the name of a large clearing house like Cede & Co.[26] ("the Depositary").[27] As far as the issuer can tell from its stock records, the Depositary owns a large number of shares and should simply be counted as a single shareholder of record. Without taking some steps to find out, the issuer does not know who actually owns this stock.[28]

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securities issued by certain regulated lending institutions and insurance companies. *Id.* § 78*l*(g)(2). An issuer that does not meet the requirements of Section 12(g) could still register voluntarily.

23. 17 C.F.R. § 240.12g5-1(a).

24. *Id.*

25. *Id.* § 240.12g5-1(b)(3).

26. Cede & Co. is the nominee name for the Depository Trust Company (DTC). DTC is the primary depository where security certificates are deposited or transferred by participants such as brokerage firms. DTC clears and settles stock trades, allowing buyers and sellers to exchange securities electronically. DTC is owned by the Depository Trust and Clearing Corporation, which in turn is owned by several banks, brokerage houses, and trading exchanges. In practice, the terms "DTC" and "Cede & Co." are used interchangeably.

27. According to the Commission: "Under street name registration, your firm will keep records showing you as the real or 'beneficial' owner, but you will not be listed directly on the issuer's books. Instead, your brokerage firm (or some other nominee) will appear as the owner on the issuer's books." U.S. Securities and Exchange Commission, Holding Your Securities—Get the Facts, http://www.sec.gov/investor/pubs/holdsec.htm (last visited Jan. 4, 2006).

28. One observer has remarked:

The use of securities depositories has not entirely eliminated the use of paper

Although it is the named shareholder, the Depositary does not own the certificate for itself. Rather, the Depositary maintains constantly updated records of the banks and broker-dealers that hold a position in the stock and how many shares they hold. Further down the line, the banks and broker-dealers are, of course, not the actual owners of the stock—their customers are. Institutional custodians such as the Depositary are *not* counted as single holders of record. Instead, each of the Depositary's accounts is counted as a record holder. In other words, securities held in street name are held of record only by the bank or broker—not the ultimate beneficial owners.[29] Thus, under current rules if the Depositary held an issuer's stock for the account of two brokerage firms which, in turn, held the stock in street name for several thousand of their customers, only the two brokerage firms would be counted toward the 500-record shareholder threshold of Section 12(g), not the thousands of beneficial owners.[30]

As discussed below,[31] an issuer that has registered a class of securities under Section 12(g) but later discovers it has fewer than 300 record holders may deregister that class.[32] If the issuer is not otherwise subject to Sections 12(b) or

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> certificates. Instead, a paper certificate representing equity ownership on the corporate books remains in place as a "global certificate" with DTC's nominee, CEDE & Co., as the "holder of record", representing all of the shares held in accounts of the brokerage firm members of DTC. These global certificates gather dust in a vault in the Wall Street area. In turn, the accounts of the brokerage firm members of DTC represent ownership by the many beneficial owners of those securities who are clients of the brokerage firms. Stock certificates are immobilized because the "global certificate" never moves from the vault.

Stephen Nelson, Petition for Commission Action to Require Exchange Act Registration of Over-the-Counter Equity Securities, Commission File No. 4-483 (July 3, 2003), http://www.sec.gov/rules/petitions/petn4-483.htm [hereinafter Nelson Petition].

29. As the Commission has stated: "Institutional custodians, such as Cede & Co. and other commercial depositories, are not single holders of record . . . . Instead, each of the depository's accounts for which the securities are held is a single record holder. In contrast, securities held in street name by a broker-dealer are held of record under the rule only by the broker-dealer." U.S. SECURITIES AND EXCHANGE COMMISSION, DIVISION OF CORPORATION FINANCE, MANUAL OF PUBLICLY AVAILABLE TELEPHONE INTERPRETATIONS EXCHANGE ACT RULES, Question (30) (1997), *available at* http://www.sec.gov/interps/telephone/cftelinterps_exchangeactrules.pdf.

30. The original version of Rule 12g5-1 that was proposed in 1964 would have required the inclusion of the ultimate beneficial holders (or at least an estimate of them) in the count. Notice of Proposed Rules 12g5-1 and 12g5-2 Under the Securities Exchange Act of 1934, Exchange Act Release No. 34-7426, 1964 WL 66562. Although this requirement was dropped from the final version of the rule, it is required for foreign issuers. *See* 17 C.F.R. § 240.12g3-2.

31. See *infra* notes 221-23 and accompanying text for a discussion of the procedure for deregistering securities under Section 12(g).

32. Under Exchange Act Rule 12g-4(a)(1)(ii), the class may also be deregistered under Section 12(g) if it is held by fewer than 500 record holders and the issuer's total assets did not exceed $10 million on the last day of any of its last three fiscal years. 17 C.F.R. § 240.12g-4. For sake of simplicity, however, this Article will usually refer only to the 300-record holder test, on the

15(d), it will thereafter cease to be subject to the Exchange Act's reporting requirements, even if the issuer has several thousand beneficial—but not record—security holders.[33] This explains why many issuers may have active trading markets for their stock yet escape the requirements of the Exchange Act.

### *B. Exchange Act Reporting Requirements*

Although a full discussion of the requirements imposed on issuers by the Exchange Act is beyond the scope of this Article, the following summary is useful to compare these requirements to those imposed on non-Exchange Act issuers. As evident from the discussion below, vast amounts of information about public issuers are available to the public. This information is easily retrievable because virtually all documents that Exchange Act issuers are required to file with the Commission are available on the Commission's EDGAR database online, as well as many third-party websites.[34] In contrast, Pink Sheets issuers need disclose very little information.[35]

Section 13(a) of the Exchange Act[36] allows the Commission to specify periodic reports that issuers must file. The Commission requires many different reports, the most important being Annual Reports on Form 10-K, Quarterly

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assumption that most affected issuers will have more than $10 million of total assets.

33. The danger in this scenario is that many beneficial holders may thereafter wish to obtain stock certificates, thereby becoming record holders. If the number of record holders were to increase to 500 or more, the issuer would again have to register the class of securities under Section 12(g). For this reason, an issuer contemplating deregistering a class under Section 12(g) should determine how many beneficial owners it has. There are a few ways to do so. First, when the issuer prints its proxy statement for a meeting of shareholders pursuant to the Commission's proxy rules under Section 14 of the Exchange Act, 15 U.S.C. § 78n (2000), each brokerage firm with a position in the stock as of the record date for that meeting must inform the issuer of the number of its customers who are beneficial owners of the stock. *See* Exchange Act Rule 14b-1(b)(1), 17 C.F.R. § 240.14b-1.

Another indicator of the number of beneficial owners is a non-objecting beneficial owner ("NOBO") list, which does not require that there be a shareholder meeting on the horizon. Exchange Act Rule 14b-1(b)(3), 17 C.F.R. § 240.14b-1. This requires brokers, dealers, and banks to provide Exchange Act issuers, upon request, with the names, addresses, and securities positions of their customers who are beneficial owners of the issuer's securities, so long as the customers have not objected to that disclosure. *Id.* However, because not all beneficial owners will consent to this disclosure, a NOBO list will not provide an exact count of the number of beneficial owners.

34. EDGAR is the Commission's "electronic data gathering and retrieval" system, which is governed by Regulation S-T. Rule 101 of Regulation S-T specifies which documents must be filed electronically on EDGAR, which documents are permitted but not required to be filed on EDGAR, and which documents may be filed only in paper. 17 C.F.R. § 232.101 (2005). The end result of this rule is that virtually all important documents that an issuer is required to file with the Commission must be filed via EDGAR.

35. *See infra* notes 151-97 and accompanying text.

36. 15 U.S.C. § 78m (2000).

Reports on Form 10-Q, and Current Reports on Form 8-K.[37]

Form 10-K[38] requires extensive annual information about the company. Some of the most important sections of Form 10-K are Items 8 and 7. Item 8 requires annual financial statements prepared in accordance with generally accepted accounting principles ("GAAP")[39] and additional Commission requirements[40] and audited by an accounting firm that meets stringent independence requirements.[41] Item 7, which is "Management's Discussion and Analysis of Financial Condition and Results of Operations" ("MD&A"), is a companion piece to the financial statements that should—at least if done well—explain the issuer's financial statements and results in sufficient detail to allow investors to make informed investment decisions about the issuer's securities.[42] Form 10-Q,[43] which an Exchange Act issuer must file after its first three fiscal quarters each year, principally requires quarterly (non-audited) financial statements and MD&A. Form 8-K specifies a long list of events or conditions that must be disclosed on a rapid basis, such as the entry into or termination of certain "material" contracts, acquisitions or dispositions of significant amounts of assets, certain off-balance sheet arrangements, changes in control of the issuer or changes in its accountants, and "guidance" if the issuer determines that prior financial statements "should no longer be relied upon."[44]

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37. Section 12 and Section 15(d) companies are also subject to Regulation FD (or, fair disclosure), the basic purpose of which is to require such companies to report to the public any previously nonpublic material information that is disclosed to certain third parties. 17 C.F.R. §§ 243.100-.103 (2005).

38. 17 C.F.R. § 249.310 (2005).

39. *See* SEC Regulation S-X, Rule 4-01(a)(1), 17 C.F.R. § 210.4-01 (2005) (providing that financial statements which are not prepared in accordance with GAAP "will be presumed to be misleading or inaccurate, despite footnote or other disclosures").

40. *See generally* SEC Regulation S-X, *id.* pt. 210.

41. *See* SEC Regulation S-X, Rule 2-01(b), (c), *id.* § 210.2-01.

42. The precise requirements for the MD&A section are set forth in Item 303 of Regulation S-K, 17 C.F.R. § 229.303 (2005). As the Commission has observed:

> The MD&A requirements are intended to satisfy three principal objectives: [t]o provide a narrative explanation of a company's financial statements that enables investors to see the company through the eyes of management; [t]o enhance the overall financial disclosure and provide the context within which financial information should be analyzed; and [t]o provide information about the quality of, and potential variability of, a company's earnings and cash flow, so that investors can ascertain the likelihood that past performance is indicative of future performance.

Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations, Securities Act Release No. 33-8350, Exchange Act Release No. 34-48960, 68 Fed. Reg. 75,056, 75,056 (Dec. 29, 2003) (to be codified at 17 C.F.R. pts. 211, 231, 241) (footnotes and bullet points omitted).

43. 17 C.F.R. § 249.308a.

44. *See* Form 8-K, Item 4.02, *id.* § 249.308. Form 8-K was amended in March 2004 to require disclosure of several additional events or conditions affecting the issuer. *See* Additional

### *C. Some Other Exchange Act Requirements*

The Exchange Act imposes many additional requirements on Section 12 registrants. For example, Section 13(d)[45] requires a security holder (or a group acting in concert) to file a report with the Commission once it beneficially owns more than five percent of the outstanding units of a class of Section 12 equity securities. This report, Schedule 13D,[46] requires not only information about the holder (or group) but also information about the holder's (or group's) plans for the issuer.[47]

Section 16(a) requires reports concerning transactions in an issuer's securities by its officers and directors, as well as persons who own more than ten percent of the outstanding shares of a class of the issuer's equity securities.[48] Section 16(b), which is a presumed insider trading prohibition, requires these persons to remit to the issuer any actual or hypothetical profit resulting from a matched purchase and sale (or sale and purchase) of the issuer's securities that occur within six months of one another.[49] Section 14 of the Exchange Act[50] and related Commission rules create a complex scheme of proxy regulation. One of the most important proxy rules is Rule 14a-3,[51] which provides that proxy solicitations may not occur unless each person solicited is furnished a proxy statement that contains the information specified in Schedule 14A[52] and, if the meeting is an annual meeting, with an annual report (often called the "glossy" annual report) that contains much of the information that is included in Form 10-K. As one might expect, Schedule 14A requires extremely detailed information

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Form 8-K Disclosure Requirements and Acceleration of Filing Date, Securities Act Release No. 33-8400, Exchange Act Release No. 34-49424, 69 Fed. Reg. 15,594 (Mar. 25, 2004) (to be codified at 17 C.F.R. pts. 228, 229, 230, 239, 240, and 249); *see also* Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date; Correction, Securities Act Release No. 33-8400A, Exchange Act Release No. 34-49424A, 69 Fed. Reg. 48,370 (Aug. 10, 2004) (to be codified at 17 C.F.R. pts. 239 and 249).

45. 15 U.S.C. § 78m (2000).

46. Schedule 13G, which is less detailed than Schedule 13D, may be used in some limited circumstances. *See* Exchange Act Rule 13d-1(b), 17 C.F.R. § 240.13d-1 (2005).

47. Specifically, Schedule 13D requires disclosure of the reporting persons' plans or proposals that would result in, among other things, the acquisition or disposition of securities of the issuer; an "extraordinary corporate transaction, such as a merger, reorganization or liquidation, involving the issuer or any of its subsidiaries"; a "sale or transfer of a material amount of assets of the issuer or any of its subsidiaries"; any "change in the present board of directors or management"; any material change in the issuer's capitalization or dividend policy; and any "other material change in the issuer's business or corporate structure." *Id.* § 240.13d-101.

48. 15 U.S.C. § 78p (2000).

49. *Id.*

50. 15 U.S.C. § 78n (2000).

51. 17 C.F.R. § 240.14a-3(a).

52. *Id.* § 240.14a-101.

in an issuer's proxy statement for even routine annual shareholder meetings. For example, for meetings at which directors will be elected Schedule 14A requires information about nearly every conceivable form of compensation that the issuer pays its Chief Executive Officer and up to four other highly paid executive officers.[53]

### *D. Increased Requirements Under SOX*

Even though the Exchange Act already required extensive disclosures, SOX substantially increased the burden on public companies. Although the following discussion is not a comprehensive description of SOX, a review of some of the important provisions of the statute and related rulemaking shows that the recent trend has been toward much greater regulation of public companies and may explain why many companies are fleeing the Exchange Act.[54]

*1. Audit Committee Requirements.*—Section 301 of SOX[55] directed the Commission to adopt a rule preventing each national securities exchange (e.g., NYSE) and national securities association (e.g., NASDAQ)[56] from listing the securities of issuers that are not in compliance with certain audit committee requirements.[57] The centerpiece of these new rules is Exchange Act Rule 10A-3.[58] Under this rule, the exchange/association rules must require all audit committee members to be "independent" of the issuer, subject to some limited exceptions.[59] Further, the exchange/association rules must require the audit

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53. *See* SEC Regulation S-K, Item 402, 17 C.F.R. § 229.402 (2005).

54. As discussed below, the Commission recently established an advisory committee to study the impact of SOX and other federal securities laws on small public companies and recommend changes in the laws that would serve to lessen this burden while still maintaining adequate investor protection. *See infra* note 357. The committee plans to issue a final report with its recommendations in April 2006. As such, it is likely that the Commission will act on many of these recommendations and thereby reduce the regulatory burden imposed by the securities laws on small public companies.

Meanwhile, however, two other sources of rules have worked to increase the regulatory burden on public companies. First, the securities exchanges and NASDAQ have significantly increased their corporate governance requirements. *See infra* notes 138-43 and accompanying text. Second, many proxy voting advisory service firms such as Institutional Shareholders Services award "points" for compliance with certain standards, whether or not the standards are required by law or exchange/association rules. For example, under some of the proxy voting advisory service firms' rating systems, a company's rating is better if it has a nominating committee that is composed only of independent directors, despite the availability of some exceptions to this requirement under Commission and exchange/association rules.

55. Codified at Section 10A(M) of the Exchange Act, 15 U.S.C.A. § 78j-1 (West 2005).

56. The Commission recently approved the application of the Nasdaq Stock Market, Inc. to register as a national securities exchange. *See supra* note 16.

57. 17 C.F.R. § 240.10A-3(a).

58. *Id.* § 240.10A-3.

59. *Id.* § 240.10A-3(b)(1)(i).

committee to establish procedures for investigating complaints "regarding accounting, internal accounting controls, or auditing matters" and the "confidential, anonymous submission by employees . . . of concerns regarding questionable accounting or auditing matters."[60] Also, pursuant to SOX Section 407 and related Commission rules, a public issuer must periodically disclose whether its audit committee has at least one member who is an "audit committee financial expert."[61]

*2. Financial Statement Certification Requirements.*—SOX imposed two new certification requirements for periodic[62] Exchange Act reports. First, Section 906[63] provides that each periodic Exchange Act report that contains financial statements must be accompanied by a certification by the issuer's chief executive officer ("CEO") and its chief financial officer ("CFO") that the report "fully complies" with the requirements of Section 13(a) or Section 15(d) of the Exchange Act and that the information in the report "fairly presents, in all material respects, the financial condition and results of operations of the issuer."[64] Second, Section 302, along with new Commission rules,[65] requires the CEO and CFO to certify in each annual and quarterly Exchange Act report that they have reviewed the report. This certification is an acknowledgment that, based on their knowledge, the report does not contain any untrue statements or omit material facts and that the financial statements and other information fairly present, in all material respects, the issuer's financial condition and results of operations.

*3. Enhanced Financial Disclosures.*—As required by Sections 401(a) and

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60. *Id.* § 240.10A-3(b)(3).

61. 17 C.F.R. § 229.401 (2005). Item 401(h) of Regulation S-K defines an "an audit committee financial expert" as a person who has certain attributes, including

> [e]xperience preparing, auditing, analyzing or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of issues that can reasonably be expected to be raised by the [issuer's] financial statements, or experience actively supervising one or more persons engaged in such activities" and an "understanding of internal control over financial reporting.

*Id.* Item 401(h) further specifies that such a person must have attained these attributes through education and specified types of experience or "[o]ther relevant experience." *Id.* § 229.401(h)(3).

62. "Periodic" reports include annual reports on Form 10-K and quarterly reports on Form 10-Q. *See* SEC Regulation S-K, Item 601(a), (b)(31), (b)(32), *id.* § 229.601.

63. Codified at 18 U.S.C.A. § 1350 (West 2005).

64. *Id.* § 1350(b). Section 906 specifies that whoever certifies a Section 906 report "knowing" that the periodic report does not comport with the requirements of Section 906 shall be fined up to $1 million or imprisoned up to ten years. *Id.* § 1350(c). Persons who "willfully" certify a Section 906 report "knowing" that the periodic report does not comport with the requirements of Section 906 shall be fined up to $5 million or imprisoned up to twenty years. *Id.*

65. *See* Exchange Act Rule 13a-14(a), 17 C.F.R. § 240.13a-14; SEC Regulation S-K, Item 601(b)(31), 17 C.F.R. § 229.601.

(b) of SOX, the Commission amended the MD&A portions of Form 10-K[66] to require issuers to explain any "off-balance sheet" arrangements. It also adopted Regulation G,[67] which requires issuers that release any non-GAAP financial measure also to present the most directly comparable GAAP financial measure and a reconciliation of the non-GAAP measure to the GAAP measure.

*4. Internal Controls Report.*—From an issuer's perspective, probably the most onerous provision of SOX is Section 404, which directed the Commission to adopt rules that would require each annual report (e.g., Form 10-K) to contain an internal controls report (1) stating management's responsibility for establishing and maintaining an "adequate internal control structure and procedures for financial reporting" and (2) containing an assessment of the effectiveness of structure and procedures.[68] In June 2003, the Commission issued final rules on this topic,[69] which were effective as of August 14, 2003, although the rules contained phased-in compliance dates.[70] The centerpiece of the new

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66. *See* Regulation S-K, Item 303(a)(4), 17 C.F.R. § 229.303. These amendments were implemented pursuant to Disclosure in Management's Discussion and Analysis of Off-Balance Sheet Arrangements and Aggregate Contractual Obligations, Securities Act Release No. 33-8182, Exchange Act Release No. 34-47264, 68 Fed. Reg. 5982 (Feb. 5, 2003) (to be codified at 17 C.F.R. pts. 228, 229, and 249).

67. 17 C.F.R. 244.100 (2005). This part was adopted in Conditions for Use of Non-GAAP Financial Measures, Securities Act Release No. 33-8176, Exchange Act Release No. 34-47226, 68 Fed. Reg. 4820 (Jan. 30, 2003) (to be codified at 17 C.F.R. pts. 228, 229, 244, and 249).

68. Codified at 15 U.S.C.A. § 7362 (West 2005).

69. Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Securities Act Release No. 33-8238, Exchange Act Release No. 34-47986, Investment Company Act Release No. 26068, 68 Fed. Reg. 36,636 (June 18, 2003) (to be codified at 17 C.F.R. pts. 210, 228, 229, 240, 249, 270, and 274).

70. *Id.* Specifically, the release specified that, for non-investment companies, companies that were "accelerated filers" as defined in Exchange Act Rule 12b-2, 17 C.F.R. § 240.12b-2, as of the end of their first fiscal year ending on or after June 15, 2004, must begin to comply in annual reports for that fiscal year. Other companies were given until their first fiscal year ending on or after April 15, 2005. These compliance dates were later extended in Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Securities Act Release No. 33-8392, Exchange Act Release No. 34-49313, Investment Company Act Release No. 26,357, 69 Fed. Reg. 9722 (Mar. 1, 2004) (to be codified at 17 C.F.R. pts. 210, 228, 229, 240, 249, 270, and 274). As a result of this release, accelerated filers have been subject to the Section 404 reporting requirements since fiscal years that ended on or after November 15, 2004. In September 2005, however, the Commission issued a final rule that extended the deadline for internal controls reports by non-accelerated filers for an additional year, i.e., to fiscal years ending on or after July 15, 2007. Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports of Companies That Are Not Accelerated Filers, Securities Act Release No. 33-8618, Exchange Act Release No. 34-52492, 70 Fed. Reg. 56,825 (Sept. 29, 2005) (to be codified at 17 C.F.R. pts. 210, 228, 229, 240, and 249). The internal controls report is a major focus of the Commission's Advisory Committee on Smaller Public Companies. *See infra* note 357.

rules is Exchange Act Rule 13a-15,[71] which requires a public issuer to (1) maintain disclosure controls and procedures (as defined in the rule) and internal control over financial reporting (as defined in the rule); (2) evaluate the effectiveness of its disclosure controls and procedures as of the end of each fiscal quarter; (3) evaluate the effectiveness of its internal control over financial reporting as of the end of each fiscal year; and (4) evaluate any change in its internal control over financial reporting that occurred during a fiscal quarter and that has materially affected, or is reasonably likely to materially affect, the issuer's internal control over financial reporting.[72] Moreover, the evaluation of the issuer's internal control over financial reporting must be done in a "suitable, recognized control framework that is established by a body or group that has followed due-process procedures, including the broad distribution of the framework for public comment."[73] Disclosure about these items must be included in an issuer's Form 10-K pursuant to new Items 307 and 308 of Regulation S-K.[74] Furthermore, Section 404(b) of SOX requires the issuer's independent auditors to attest to and report on the issuer's assessments made under Section 404(a).[75] Complying with these new requirements will entail enormous amounts of management effort, as well as a great deal of additional fees payable to the issuer's independent auditors.

*5. Auditor Requirements.*—Public accounting firms may no longer provide non-audit services to public companies contemporaneously with audit services, with some exceptions.[76] SOX also created the Public Company Accounting Oversight Board[77] ("PCAOB") and required public accounting firms to register with the PCAOB. The PCAOB has authority to establish "auditing, quality control, ethics, independence, and other standards relating to the preparation of

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71. 17 C.F.R. § 240.13a-15. For Section 15(d) issuers, see Exchange Act Rule 15d-15, *id.* § 240.15d-15.

72. *Id.* § 240.13a-15.

73. Exchange Act Rule 13a-15(c), *id.*

74. 17 C.F.R. § 229.307, .308 (2005); *see also* Form 10-K, Item 9A, 17 C.F.R. § 249.310 (2005); Form 10-Q, Item 4, *id.* § 249.308a.

75. To this end, the Commission amended Rules 1-02 and 2-02 of Regulation S-X to require such reports, which now must appear in Forms 10-K. 17 C.F.R. §§ 210.1-02(a), .2-02(f) (2005). *See* Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Securities Act Release No. 33-8238, Exchange Act Release No. 34-47986, Investment Company Act Release No. 26068, 68 Fed. Reg. 36,636 (June 18, 2003) (to be codified at 17 C.F.R. pts. 210, 228, 229, 240, 249, 270, and 274).

76. Exchange Act § 10A(g), (h) and (i), 15 U.S.C.A. § 78j-1 (West 2005), as added by Sections 201 and 202 of SOX. Some non-audit activities are completely prohibited, such as bookkeeping or other services related to accounting records or financial statements; financial information systems design and implementation; appraisal or valuation services; fairness opinions; broker or dealer, investment advisor, or investment banking services; and legal services and expert services unrelated to the audit. *Id.* §§ 78j-1(g), (h).

77. *See* Sarbanes-Oxley Act of 2002 §§ 101-09, Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified as amended in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

audit reports for [public] issuers,"[78] among other powers.

*6. Code of Ethics for Senior Financial Officers.*—Section 406 of SOX directed the Commission to adopt rules requiring public companies to disclose whether they have a code of ethics for certain senior officers and, if not, why not. The new rule, which is found in Item 406 of Regulation S-K,[79] requires the code to be "reasonably designed to deter wrongdoing and to promote," among other things; "[h]onest and ethical conduct"; "[f]ull, fair, accurate, timely, and understandable disclosure in [Exchange Act] reports"; and compliance with laws.[80]

*7. Acceleration of Periodic Reporting Deadlines.*—Pursuant to Section 409 of SOX,[81] the Commission designated some large public companies as "accelerated filer[s]."[82] These companies will eventually[83] be required to file their Forms 10-K within sixty days after the end of their fiscal years (as opposed to the ninety days allowed in pre-SOX days) and their Forms 10-Q within forty days after the end of their fiscal quarters (as opposed to forty-five days, before SOX).[84]

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78. *See id.* § 101(c)(2).

79. 17 C.F.R. § 229.406.

80. *Id.* This disclosure is required under Item 10 of Form 10-K. 17 C.F.R. § 249.310 (2005). In addition, Item 406 specifies that the actual text of the code must appear as an exhibit to the annual report or on the company's website (in which case the company must disclose in its annual report that it has posted the code on its website). *Id.* Alternatively, the company may undertake in its annual report to provide to any person a copy of the code. *Id.*

81. Codified at Section 13(*l*) of the Exchange Act, 15 U.S.C.A. § 78m (West 2005).

82. *See* Exchange Act Rule 12b-2, 17 C.F.R. § 240.12b-2 (2005).

83. In Temporary Postponement of the Final Phase-In Period for Acceleration of Periodic Report Filing Dates, Securities Act Release No. 33-8507, Exchange Act Release No. 34-50684, 69 Fed. Reg. 68,232 (Nov. 23, 2004) (to be codified at 17 C.F.R. pts. 210, 240, and 249) (postponing the final phase-in of these requirements). Under that amended schedule, an accelerated filer was to file its annual report within sixty days after its fiscal year ending on or after December 15, 2005, and its next three quarterly reports within thirty-five days after the end of the quarter. *Id.* However, in December 2005, the Commission adopted rule changes to segregate "large accelerated filers," which are those with a public float (the market value of common equity held by persons who are not affiliates of the issuer) of $700 million or more, from mere "accelerated filers," which are those with a public float between $75 million and $700 million. Revisions to Accelerated Filer Definition and Accelerated Deadlines for Filing Periodic Reports, Securities Act Release No. 33-8644, Exchange Act Release No. 34-52989, 70 Fed. Reg. 76,626 (Dec. 27, 2005) (to be codified at 17 C.F.R. pts. 210, 229, 240, and 249). Under the new schedule, only large accelerated filers will be subject to the final phase-in of the sixty-day annual report filing deadline. This sixty-day deadline will apply to annual reports for fiscal years ending on or after December 15, 2006. Until then, the deadline is seventy-five days. "Regular" accelerated filers will continue to have seventy-five days to file annual reports, and *both* large accelerated filers and "regular" accelerated filers will continue to have forty days to file quarterly reports.

84. *See* Form 10-K, Instruction A(2), 17 C.F.R. § 249.310; Form 10-Q, Instruction A(1), *id.* § 249.308a.

*8. Attorney Conduct Rules.*—Section 307 of SOX required the Commission to promulgate new rules applicable to attorneys representing public issuers. The purpose of the new rules[85] is to require attorneys who become aware of evidence of a past, pending, or imminent "material violation" involving an Exchange Act issuer or certain subsidiaries to report it to the issuer.[86] "Material violations" include material violations of applicable federal or state securities laws, breaches of fiduciary duties under federal or state law, and "similar" violations of any federal or state law.[87] In addition to reporting this evidence, the attorney must also determine whether the issuer adopts an "appropriate response."[88]

*9. Nominating Committee Functions and Shareholder Communications with Directors.*—Although not required by SOX, the Commission adopted new rules imposing on public companies additional disclosure requirements with respect to the functions of the nominating committees of their boards of directors.[89] The Commission also amended Schedule 14A to require that an issuer state whether its board "provides a process for security holders to send communications to the board of directors and, if the registrant does not have such a process . . . state the basis for the view of the board of directors that it is appropriate for the registrant not to have such a process."[90]

Again, this summary is not a comprehensive description of the obligations that the Exchange Act imposes on public issuers or how those requirements have increased under SOX. Rather, it is intended to remind the reader of the extensive regulation to which public companies are subject and the vast amount of information about them that is consequently available to the public easily and free of charge. As the Commission has observed, the information contained in Exchange Act reports "is a treasure trove for investors."[91] It is easy to see why.

### *E. A Brief Overview of the U.S. Securities Markets*

*1. National Securities Exchanges.*—The "hallmark of a stock exchange

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85. 17 C.F.R. pt. 205 (2005).

86. *Id.* § 205.3.

87. *Id.* § 205.2.

88. *Id.* § 205.3(b)(3).

89. Disclosure Regarding Nominating Committee Functions and Communications Between Security Holders and Boards of Directors; Republication, Securities Act Release No. 33-8340, Exchange Act Release No. 34-48825, Investment Company Act Release No. 26,262, 68 Fed. Reg. 69,204 (Dec. 11, 2003) (to be codified at 17 C.F.R. pts. 228, 229, 240, 249, 270, and 274). A public company whose board of directors has a nominating committee must disclose certain information about the committee's charter (if it has one), and provide shareholders with access to a copy of the charter, either in the proxy statement itself or on the company's website. *See* Schedule 14A, Items 7(d)(2)(ii)(A), (B), 17 C.F.R. § 240.14a-101 (2005). Item 7(d)(2), as recently amended, also requires detailed information about the nominating committee and the process for identifying and evaluating nominees for director. *Id.*

90. Schedule 14A, Item 7(h)(1), 17 C.F.R. § 240.14a-101.

91. Microcap Stock, *supra* note 11.

historically has been the centralization of trading on an exchange floor."[92] Before automation, this meant that each order for a stock would be communicated to a "specialist" in that stock at his or her post on the exchange floor, usually by a floor broker physically carrying the order to the specialist.[93] There are several securities exchanges registered with the Commission, the most prominent being NYSE and the American Stock Exchange ("AMEX").[94] Nearly 2800 companies have securities listed on NYSE[95] and approximately 800 have securities listed on AMEX.[96] NYSE is the largest stock exchange,[97] and its listed companies had a combined market capitalization (number of shares outstanding multiplied by the value of the shares) of more than $12.1 trillion at the end of 2003.[98] The volume of trading activity on NYSE is staggering: average daily share volume in 2003 was nearly 1.4 billion shares, and the total value of trades on NYSE during 2003 was nearly $9.7 trillion.[99] The second largest national stock exchange has historically been AMEX, although it is much smaller than NYSE. AMEX's listed companies had a combined market capitalization of more than $176 billion at the end of 2003.[100] AMEX's average daily share volume in 2003 was more than 67 million shares, and the total value of trades on AMEX during 2003 was more than $563 billion.[101] The smaller exchanges represent

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92. 5 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 2525 (3d ed., rev. vol. 2001). Section 3(a)(1) of the Exchange Act, 15 U.S.C. § 78c (2000), defines an "exchange." Sections 5 and 6 of the Exchange Act, 15 U.S.C. §§ 78e, 78f (2000), in effect require all exchanges to be registered as national securities exchanges.

93. 5 LOSS & SELIGMAN, *supra* note 92, at 2527. For a more detailed description of the process for placing securities orders, see *id.* at 2527-28.

94. The other stock exchanges are the Pacific Exchange, the Chicago Stock Exchange, the National Stock Exchange (formerly the Cincinnati Stock Exchange), the Boston Stock Exchange, the Philadelphia Stock Exchange, and the Chicago Board Options Exchange ("CBOE"), "although the CBOE does not appear currently to have any volume in stock trades." *Id.* at 2525 n.76. The International Securities Exchange is also registered as a national securities exchange.

95. *See* New York Stock Exchange, Listed Companies, http://www.nyse.com/about/listed/1089312755443.html (last visited Jan. 4, 2006).

96. *See* American Stock Exchange, http://www.amex.com (last visited Jan. 4, 2006). Some companies may have securities listed on more than one exchange.

97. 5 LOSS & SELIGMAN, *supra* note 92, at 2529 ("As of 1998, the NYSE was responsible for 88 percent of the dollar value of the stocks traded on exchanges and 87 percent of the shares traded." (citations omitted)).

98. SECURITIES INDUSTRY ASSOCIATION, SECURITIES INDUSTRY FACT BOOK 43 (2004).

99. *Id.* at 46. Based on an average stock price of $27.50, the average value of the NYSE average daily share volume in 2003 was nearly $38.5 billion. In 2004, average daily share volume was more than 1.4 billion shares, with an average daily dollar value of trading of more than $46.1 billion. *See* New York Stock Exchange, NYSE Market Statistics, http://www.nyse.com/marketinfo/1022221393893.html (last visited Jan. 5, 2006).

100. SECURITIES INDUSTRY ASSOCIATION, *supra* note 98, at 43.

101. *Id.* at 48. Based on an average stock price of $33.30, the average value of the AMEX average daily share volume in 2003 was more than $2.2 billion.

only about one percent of the market capitalization of listed companies.[102]

*2. NASDAQ.*—Unlike securities exchanges, the over-the-counter ("OTC") markets do not exist in any physical trading location, instead existing among dealers who communicate electronically and by telephone. Of the OTC markets, NASDAQ is the best known. Its two main markets are the National Market System and the Capital Market (formerly known as the SmallCap Market).[103] The National Market System is primarily for large, well-established companies; whereas, the Capital Market is designed for smaller companies. This difference is reflected in the listing criteria for the two markets; it is more difficult for a company to qualify for the National Market System than the Capital Market.[104]

Before 1971, quotations in OTC stocks were reported only in the Pink Sheets, which was then a daily publication of the National Quotations Bureau.[105] Brokers and dealers thus had to call one of the dealers in a particular OTC security to get current quotations for it, resulting in an inefficient market.[106] This situation improved when NASDAQ debuted in 1971 as the world's first electronic stock market. As commentators observed: "In the early 1970s, over-the-counter trading was revolutionized by the replacement of the daily 'pink sheets' with the NASDAQ electronic system, which permitted brokers to read up-to-the-minute . . . quotations from desk top terminals."[107] On February 8, 1971, its first day of trading, NASDAQ displayed quotations for more than 2500 OTC stocks.

At the end of 2003, NASDAQ's listed companies had a combined market capitalization of nearly $3 trillion.[108] NASDAQ's average daily share volume in 2003 was nearly 1.7 billion shares, and the total value of trades on NASDAQ during 2003 was more than $7 trillion.[109] Today, NASDAQ says that "[w]ith approximately 3,300 companies, it lists more companies and, on average, trades more shares per day than any other U.S. market."[110]

*3. The OTC Bulletin Board.*—The OTCBB is a "regulated quotation service

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102. 5 LOSS & SELIGMAN, *supra* note 92, at 2531. Only a small number of stocks are exclusively listed on one of these "regional" exchanges; most are dually listed on another exchange. *Id.*

103. NASDAQ also has a PORTAL market for transactions in securities governed by Rule 144A under the Securities Act of 1933, 17 C.F.R. § 230.144A (2005). The Commission recently approved the application of the Nasdaq Stock Market, Inc. to register as a national securities exchange. *See supra* note 16.

104. *See infra* notes 133-35 and accompanying text.

105. 5 LOSS & SELIGMAN, *supra* note 92, at 2605.

106. *Id.* ("[T]he time and difficulty involved in telephoning over-the-counter dealers frequently discouraged brokers or dealers placing orders from engaging in rigorous comparative shopping.").

107. *Id.* at 2487.

108. SECURITIES INDUSTRY ASSOCIATION, *supra* note 98, at 43.

109. *Id.* at 47. Based on an average stock price of $16.62, the average value of the NASDAQ average daily share volume in 2003 was more than $28 billion.

110. NASDAQ.com, Overview, http://www.nasdaq.com/about/overview.stm (last visited Jan. 5, 2006).

that displays real-time quotes, last-sale prices, and volume information in over-the-counter (OTC) equity securities."[111] Although the OTCBB is operated by the NASD, companies do not apply to list their securities on the OTCBB, as is the case with NASDAQ; instead, market makers initiate quotations for securities on the OTCBB. In fact, a company could not prevent its securities from being traded on the OTCBB. Also, quoted companies need not meet or maintain any qualitative or quantitative listing standards, as they must with NASDAQ and the securities exchanges.[112]

Section 17B(b)(1) of the Exchange Act,[113] which was added by the Penny Stock Reform Act of 1990,[114] directed the Commission to facilitate the dissemination of last sale and quotation information for penny stocks, with a goal of establishing "one or more automated quotation systems that will collect and disseminate information regarding all penny stocks." As a result, the OTCBB

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111. OTC Bulletin Board, Overview and History of the OTCBB, http://www.otcbb.com/aboutOTCBB/overview.stm (last visited Jan. 5, 2006).

112. NASDAQ previously contemplated replacing the OTCBB with a new market to be called the Bulletin Board Market, or BBX. It was envisioned that this market, unlike the OTCBB, would impose qualitative and quantitative listing requirements, in an effort seemingly designed to "clean up" the less-than-stellar reputation of the OTC market. This proposal was dropped in 2003. JAMES J. ANGEL ET AL., FROM PINK SLIPS TO PINK SHEETS: LIQUIDITY AND SHAREHOLDER WEALTH CONSEQUENCES OF NASDAQ DELISTINGS 10-11 (2004), http://www.bus.wisc.edu/finance/pdfs/Seminar/Spring2005/Angel_Harris_Panchapagesan_Werner_2004_Nov_02.pdf. *See generally* Karen Talley, *Small-Stock Focus: An Overhaul for the OTC Bulletin Board Is Set*, WALL ST. J., Jan. 21, 2003, at C7 (noting that the prior "lenient approach has led to a slew of questionable companies garnering listings on the [OTC] Bulletin Board").

113. 15 U.S.C. § 78q-2 (2000).

114. Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. 101-429, 104 Stat. 931 (1990) (codified as amended in scattered sections of 15 U.S.C. (2000)). The primary effect of the Penny Stock Reform Act of 1990 was to require that a broker-dealer give a customer certain information before effecting a transaction in a "penny stock" for that customer. Exchange Act Section 3(a)(51), 15 U.S.C. § 78c (2000), and Exchange Act Rule 3a51-1, 17 C.F.R. § 240.3a51-1 (2005), define a penny stock to include an equity security, *other than* one (among other things): (1) that is traded on a national securities exchange or NASDAQ, subject to some detailed qualifications, (2) that has a price of $5.00 or more, or (3) whose issuer meets certain tests regarding net tangible assets and revenues. 15 U.S.C. § 78c. The Commission recently amended the definition of penny stock. *See* Amendments to the Penny Stock Rules, Exchange Act Release No. 34-51983, 70 Fed. Reg. 40,614 (July 13, 2005) (to be codified at 17 C.F.R. pt. 240). Exchange Act Rules 15g-2 and 15g-9 essentially require that the broker-dealer in most cases provide the customer with a disclosure form on Schedule 15G, which gives certain warnings about penny stocks, and receive from the customer a signed acknowledgment that the customer has received the document and consents to the transaction. 17 C.F.R. §§ 240.15g-2, .15g-9. Further, the broker-dealer usually must determine that a transaction in a penny stock is "suitable" for that customer. Rules 15g-2 and 15g-9 were also recently amended by the Commission pursuant to Exchange Act Release No. 34-51983, *supra*.

began operation in June 1990, on a pilot basis.[115] In April 1997, the Commission approved the operation of the OTCBB on a permanent basis.[116] Currently, approximately 3300 securities are quoted on the OTCBB, fewer than 300 of which are quoted exclusively on the OTCBB. The remaining securities are also quoted on the Pink Sheets.[117] According to the OTCBB's website, in 2003 average daily share volume was more than one billion shares, and the dollar value of that average daily share volume was nearly $160 million.[118]

*4. The Pink Sheets.*—The Pink Sheets describes itself as:

> the leading provider of pricing and financial information for the over-the-counter (OTC) securities markets. We provide products and services that increase the transparency of information available in the OTC markets so as to make them more efficient for all participants. Our centralized information network includes services designed to benefit market makers, issuers, brokers and OTC investors. Pink Sheets information enhances the efficiency of OTC trading, provides better executions for OTC investors and improves the capital formation process for OTC issuers.
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> The origins of the Pink Sheets go back to 1904, when the National Quotation Bureau began as a paper-based, inter-dealer quotation service linking competing market makers in OTC securities across the country. Since that time, the Pink Sheets . . . have been the central resource for trading information in OTC stocks and bonds.[119]

Although it may seem to many laypeople to be simply another stock market, the Pink Sheets is not registered with the Commission because it does not fall within the definition of an "exchange," a "broker-dealer," or an exclusive "securities information processor" under the Exchange Act.[120] Further, the Pink

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115. *See* OTC Bulletin Board, *supra* note 111.

116. Although the OTCBB was created after the Penny Stock Reform Act of 1990, this does not mean that all stocks quoted on it are "penny stocks"—although approximately 94% of them are. ANGEL ET AL., *supra* note 112, at 11.

117. According to the Pink Sheets website, 4809 securities were exclusively quoted on the Pink Sheets, 271 securities were exclusively quoted on the OTCBB, and 3015 securities were dually quoted on the OTCBB and the Pink Sheets on February 2, 2006. *See* Pink Sheets, http://www.pinksheets.com/index.jsp (last visited Feb. 2, 2006); *see also* ANGEL ET AL., *supra* note 112, at 10 ("[D]espite the fact that approximately 3,200 stocks trade concurrently on both [the OTCBB and the Pink Sheets] and another 4,300 stocks trade exclusively in the Pink Sheets, very little is actually known about them in the academic community.").

118. OTC Bulletin Board, Historical Annual Statistics, http://www.otcbb.com/TradingData/HistAnnualStats.stm (last visited Jan. 5, 2006).

119. Pink Sheets, About the Pink Sheets: Revolutionizing OTC Markets, http://www.pinksheets.com/about/index.jsp (last visited Jan. 5, 2006). On February 14, 2003, the Pink Sheets began allowing issuers to sponsor real-time quotations for their stock on the Pink Sheets' website, for a fee of $174.95 per month. ANGEL ET AL., *supra* note 112, at 11.

120. *See generally* Exchange Act §§ 5, 6, 11A, 15; 15 U.S.C. §§ 78e, 78f, 78k-1, 78o (2000).

Sheets is not registered with the Commission as a self-regulatory organization ("SRO") or national securities association.[121] Thus, although brokers that use the Pink Sheets to trade securities are regulated by the NASD and the Commission, the Pink Sheets itself is simply a private entity. As discussed below, issuers with securities quoted on the Pink Sheets need not meet any qualitative or quantitative listing standards, as they must with NASDAQ and the national securities exchanges (but not the OTCBB), or be Exchange Act reporting companies, as they must with all of those other markets.[122]

Although share volume on the Pink Sheets may often exceed that of the other markets, the dollar value of those trades is significantly lower than the other markets[123] due to a much lower average price for Pink Sheets securities, often less than one dollar per share.[124] For example, in a letter to the Commission, the Pink Sheets noted that trading volume for April 2004 was over 20.6 billion shares of stock, with a market value of more than $2 billion.[125] Because there were

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The Pink Sheets website, in response to the question "Who Regulates the Pink Sheets?," puts it this way:

> Pink Sheets is neither a Securities and Exchange Commission (SEC) Registered Stock Exchange nor a NASD broker/dealer. Pink Sheets is considered a Non-exclusive Securities Information Processor and an Interdealer Quotation System, for which registration is not required under current securities laws. However, [the] Pink Sheets quotation and trading system is only open to registered broker/dealers and those broker/dealers are subject to NASD Rules and regulations regarding their conduct and use of the Pink Sheets. Issuers are subject to Federal and State securities laws.

Pink Sheets, Frequently Asked Questions, http://www.pinksheets.com/faq.jsp#9 (last visited Jan. 5, 2006).

121. *See generally* Exchange Act §§ 15A, 19, 15 U.S.C. §§ 78o-3, 78s (2000).

122. *See infra* notes 151-72 and accompanying text. The CEO of the Pink Sheets is reported as having said that "We are the tier of stuff that can't, won't, or doesn't want to be listed on the exchange." ANGEL ET AL., *supra* note 112, at 2 n.1.

123. "An estimated $75 million a day trades in Pink Sheet issues. That is still tiny compared with the $41 billion in trades averaged by the New York Stock Exchange in December . . . ." Jeff D. Opdyke, *More Blue Chips Hit the Pink Sheets*, WALL ST. J., Jan. 21, 2003, at D1; *see also* Ianthe Jeanne Dugan, *Pink Sheets Aims For Respectability Under Ex-Trader*, WALL ST. J., Dec. 17, 2005, at B1 ("Since 2003, the amount of stock traded on the Pink Sheets has more than doubled to $50 billion annually. But honest businesses are mingled with murky enterprises, which have proliferated as the Internet allows bogus information to spread quickly and small investors to trade for themselves."). Opdyke also notes that although the Pink Sheets "has long been notorious for distressed companies and dubious penny stock," it "is also home to hundreds of financially solid companies." Opdyke, *supra*; *see also* Russ Wiles, *Gazing at Penny Stocks*, ARIZ. REPUBLIC, June 30, 2003, at D1 ("[P]enny stocks make up the dark matter of the investment universe: a murky and treacherous realm of low visibility. . . . This corner of the stock market now trades more shares than Nasdaq, though the dollar value is much less.").

124. As with the OTCBB, although many Pink Sheets stocks fall within the definition of "penny stock," not all of them do. ANGEL ET AL., *supra* note 112, at 11.

125. Letter from R. Cromwell Coulson, CEO, Pink Sheets, LLC, to Jonathan G. Katz,

twenty-two trading days in April 2004, this would mean that the Pink Sheets' average daily volume was slightly less than one billion shares and approximately $91.7 million during that month.

It is very easy for stock to be traded through the Pink Sheets. Essentially, all that needs to be done is to find an NASD-member broker-dealer to quote the issuer's securities on the Pink Sheets. In most cases, this "market maker" must file a Form 211[126] with the NASD OTC Compliance Unit, along with the information required by Exchange Act Rule 15c2-11.[127] After a review by the NASD OTC Compliance Unit, quotations of the security may be entered on the Pink Sheets.[128] The form must be filed at least three business days before the quotation is entered.[129]

The former exchange-listed company that wants to move to the Pink Sheets may find this hard to believe. Unlike applying to list securities on an exchange or NASDAQ, there are no quantitative or qualitative standards for the company

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Secretary, Securities and Exchange Commission (June 24, 2004), *available at* http://www.sec.gov/rules/sro/nasd/nasd2004056/pinksheets062404.pdf. This letter stated that in April 2004, "registered broker-dealers used the services of Pink Sheets to electronically negotiate 359,515 trades in OTC equity securities consisting of 20,612,015,510 shares of stock with a market value of $2,017,438,749."

126. Form 211 is not a difficult or time-consuming form to complete. Part 1 of the form requires basic information about the issuer and the security; part 2 requires the broker-dealer to specify which portion of Rule 15c2-11 it is relying on to satisfy its informational requirements under that rule; part 3 requires some limited supplemental information; and part 4 consists of a certification for the submitting brokerage firm to sign stating, among other things, that the firm has a reasonable basis for believing that the Rule 15c2-11 information is accurate. Form 211, *available at* http://www.otcbb.com/aboutOTCBB/forms/form211.pdf (last viewed Feb. 2, 2006).

127. 17 C.F.R. § 240.15c2-11 (2005). Exceptions exist, including exceptions for unsolicited quotes and where the market maker already quotes the security in another market. *See generally id.* § 240.15c2-11(f). Under the rule, an unsolicited quote must be made (1) "solely on behalf of a customer (other than a person acting as or for a dealer)"; (2) "represent[] the customer's indication of interest"; and (3) "not involve the solicitation of the customer's interest." *Id.* The "Pink Sheets has become increasingly concerned that the unsolicited quote exception in Exchange Act Rule 15c2-11 is being abused by unscrupulous individuals to engage in questionable and possibly fraudulent activities in violation of the federal securities laws." Pink Sheets, How Does a Company Become Quoted on the Pink Sheets: Unsolicited Quotes, http://www.pinksheets.com/otcguide/issuers_getquoted.jsp (last visited Jan. 5, 2006). As such, this portion of the website notes that the Pink Sheets will only publish unsolicited quotations if (1) the issuer is subject to Exchange Act reporting requirements and is current in its reports to the Commission; (2) the securities were delisted from NYSE, the American Stock Exchange, NASDAQ or the OTCBB; (3) the issuer is a bank, savings and loan, or insurance company; (4) the securities were issued as part of a bankruptcy reorganization; (5) the security "is a foreign ordinary, which is listed on a foreign exchange, or an ADR representing such ordinaries"; or (6) the issuer has complied with the Pink Sheets Disclosure Policy discussed below. *Id.*; *see infra* notes 173-97 and accompanying text.

128. *See* Form 211, *supra* note 126.

129. *Id.*

to meet and very little for the company to do. Of course, after the issuer finds a sponsoring market maker, the market maker may ask the issuer to supply it with the information that it needs for its files under Rule 15c2-11; however, this likely presents only a minor inconvenience for the issuer. Further, many companies whose securities are quoted on the Pink Sheets will be neither subject to the Exchange Act reporting requirements nor subject to the Pink Sheets disclosure policy discussed in Part I.G.3.

### *F. Requirements of NYSE and NASDAQ*

Not every issuer may list its securities on NYSE or NASDAQ; both require issuers to meet certain quantitative tests. For example, for domestic issuers, NYSE requires that the security must have at least 2000 shareholders that each own at least 100 shares (round lot holders).[130] NYSE also has detailed requirements relating to the level of the issuer's earnings or cash flows.[131] After it is listed, the issuer must continue to meet somewhat lesser standards for its securities to remain listed.[132] Of course, since NYSE is a national securities exchange, any class of securities that is listed on NYSE must be registered under Section 12(b) of the Exchange Act, thus subjecting the issuer to the full panoply of Exchange Act (and SOX) requirements. To have its securities listed on the Nasdaq National Market System, not only must a domestic or Canadian issuer be a public company (or about to become one),[133] but it must also meet at least one of three different standards which contain criteria relating to the value of the

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130. *See* NYSE, Inc., Listed Company Manual, *supra* note 16, § 102.01(A). There are, however, alternative standards for this requirement. *See id.* § 102.01(B).

131. *Id.* § 102.01(C).

132. *See id.* § 802.01.

133. Under the *Nasdaq Marketplace Rules*, the security to be listed (if not distributed in an IPO) must be "(1) registered pursuant to Section 12(g)(1) of the [Exchange] Act; (2) registered on a national securities exchange pursuant to Section 12(b) of the Act; or (3) issued by an insurance company pursuant to Section 12(g)(2)(G) of the Act"; or (4) issued by a registered investment company, subject to certain conditions. Nasdaq Marketplace Rules § 4310(a) (2005), *available at* http://nasd.complnet.com/nasd/display/index.html (follow "Marketplace Rules" hyperlink). Because NASDAQ currently is not a national securities exchange, securities listed on it do not have to be registered under Section 12(b) of the Exchange Act. *Id.* As noted above, the Commission recently approved the application of The Nasdaq Stock Market LLC to register as a national securities exchange. *See supra* note 16. However, in the release approving this application, the Commission noted that NASDAQ's "initial and continuing listing standards [will] be largely the same as current NASD listing rules." In the Matter of the Application of The Nasdaq Stock Market LLC for Registration as a National Securities Exchange, Exchange Act Release No. 34-53128, 71 Fed. Reg. 3550, 3564 (Jan. 23, 2006) (footnote omitted). Similarly, the "corporate governance listing standards proposed for the Nasdaq Exchange are the same as those previously approved by the Commission . . . ." *Id.* The Nasdaq Marketplace Rules are Rules 4000 to 7000 of the NASD Manual (2005), *available at* www.nasd.complinet.com/nasd/display/index.html (follow "Marketplace Rules" hyperlink).

issuer's stockholders' equity, the value of its total assets or its annual revenues, the number of its publicly held shares and the market value and minimum bid price of those shares, the number of round lot shareholders, and its operating history.[134] As with NYSE, NASDAQ's continuing listing requirements are less stringent than its initial requirements.[135]

Even if an issuer meets the numerical quantitative tests, it must also meet qualitative standards concerning corporate governance issues.[136] For example, Section 3 of the *NYSE Listed Company Manual* contains detailed requirements relating to, among other things, annual shareholder meetings, shareholder voting rights, corporate governance standards, and classified boards of directors. NASDAQ's qualitative requirements relate to annual shareholder meetings, shareholder voting rights, shareholder meeting quorum requirements, the independence of directors and certain board committees, and the approval of related party transactions.[137] Moreover, both NYSE and NASDAQ recently implemented extensive changes to their corporate governance requirements to require that, among other things, a majority of directors be independent;[138] require executive sessions of independent directors;[139] impose new obligations on audit committees,[140] nominating committees,[141] and compensation committees;[142] and require codes of ethics that are applicable to all of an issuer's directors and employees.[143] In general, these new requirements complement SOX, but in many cases they go much further than SOX.

### *G. Requirements of the OTC Bulletin Board and the Pink Sheets*

Unlike NYSE and NASDAQ, there simply are no quantitative or qualitative

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134. Nasdaq Marketplace Rules, *supra* note 133, § 4310.

135. Also, it is somewhat easier to satisfy the quantitative listing requirements for the Nasdaq Capital Market. *See id.*

136. In addition, both NYSE and NASDAQ retain discretion to refuse to list the securities of an issuer that meets the quantitative requirements, or to impose greater requirements. *See* NYSE, Inc., Listed Company Manual, *supra* note 16, § 101.00; *see also* Nasdaq Marketplace Rules, *supra* note 133, at IM-4300.

137. *See* Nasdaq Marketplace Rules, *supra* note 133, §§ 4350, 4351.

138. *See* NYSE, Inc., Listed Company Manual, *supra* note 16, § 303(A).01; Nasdaq Marketplace Rules, *supra* note 133, §§ 4350(c)(1), 4200(a)(15).

139. NYSE, Inc., Listed Company Manual, *supra* note 16, § 303(A).03; Nasdaq Marketplace Rules, *supra* note 133, § 4350(c)(2).

140. NYSE, Inc., Listed Company Manual, *supra* note 16, §§ 303(A).06, .07; Nasdaq Marketplace Rules, *supra* note 133, § 4350(n).

141. NYSE, Inc., Listed Company Manual, *supra* note 16, § 303(A).04; Nasdaq Marketplace Rules, *supra* note 133, § 4350(c)(4).

142. NYSE, Inc., Listed Company Manual, *supra* note 16, § 303(A).05; Nasdaq Marketplace Rules, *supra* note 133, § 4350(c)(3).

143. NYSE, Inc., Listed Company Manual, *supra* note 16, § 303(A).10; Nasdaq Marketplace Rules, *supra* note 133, § 4350(d).

requirements for issuers whose securities are quoted on the OTCBB or the Pink Sheets. However, these issuers must make certain information available to investors, as discussed below.

*1. NASD Eligibility Rule.*—On January 4, 1999, the Commission approved the NASD's eligibility rule for the OTCBB.[144] Issuers whose securities were not already quoted on the OTCBB at that time were required, before quotation on the OTCBB, to report their current financial information to the Commission or, alternatively, banking or insurance regulators. Non-reporting companies whose securities were already quoted on the OTCBB were given until June 2000 to comply with the new requirements. Before the eligibility rule, the OTCBB quoted the securities of more than 3600 non-Exchange Act reporters.[145] After the eligibility rule was approved, the NASD began delisting noncompliant issuers from the OTCBB. More than 3000 companies were delisted.[146] What did the delisted companies do? Many of them now have their securities quoted on the Pink Sheets.[147]

In its release approving the eligibility rule, the Commission observed that one reason for the rule was that the "lack of reliable and current financial information about the issuers, and the perception by the public that the OTCBB is similar to

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144. Nasdaq Marketplace Rules, *supra* note 133, § 6530. This rule defines the securities that are eligible to be quoted on the OTCBB. For the typical domestic equity security, the rule requires (1) that the security not be listed on NASDAQ or a U.S. national securities exchange (with some exceptions) and (2) one of the following: (a) the issuer of the security is required to file reports under Section 13(a) or Section 15(d) of the Exchange Act and is current in its reports (with a thirty-day grace period), (b) the security is described in Section 12(g)(2)(B) of the Exchange Act (which deals with investment company securities registered under the Investment Company Act) and is current in its reporting obligations (subject to a thirty-day grace period), (c) "the security is described in Section 12(g)(2)(G) of the Exchange Act" (which deals with securities of certain insurance companies) and is current in its reporting obligations (subject to a sixty-day grace period), or (d) the "issuer of the security is a bank or savings association that is not required to file reports with the Commission pursuant to Section 13 or 15(d) of the Exchange Act" and is current with all required filings with its appropriate federal banking agency or state bank supervisor (subject to a sixty-day grace period).

145. Brian J. Bushee & Christian Leuz, *Economic Consequences of SEC Disclosure Regulation: Evidence from the OTC Bulletin Board*, 39 J. ACCT. & ECON. 233, 235 (2005).

146. The eligibility rule "phase-in" started on July 1, 1999, and was completed as of June 22, 2000. The NASD staff reviewed all 5601 companies whose securities were quoted on the OTCBB. This review led to 3187 companies being deemed ineligible for continued quotation and their removal from the OTCBB. However, 205 of the ineligible issuers later met the requirements. OTC Bulletin Board, Eligibility Rule, http://www.otcbb.com/news/EligibilityRule/ercomplete.stm (last visited Jan. 5, 2006).

147. "Between 1999 and 2000, OTCBB de-listed about 3,000 of its then 6,500-name roster." Peter Chapman, *The Rise of the Pink Sheets*, TRADERS, June 2003, at 42, 44. "At that time, the mass de-listing caused the number of securities quoted on the Pink Sheets . . . to surge from about 1,000 to 4,000." *Id.*

a highly regulated market, such as the registered exchanges or Nasdaq."[148] Further, the Commission stated that the NASD was concerned that "where there is no public information available regarding a security, the broad-based automated display of quotations in that security creates an unjustified perception of reliability."[149] The Commission approved the eligibility rule because it ensured that there would be current publicly available information about OTCBB issuers, which "may help to reduce fraud and manipulation."[150] One wonders why these concerns do not also apply to the Pink Sheets—did the NASD and the Commission simply change the venue for fraud and manipulation from the OTCBB to the Pink Sheets?

*2. Exchange Act Rule 15c2-11.*—Companies whose securities are quoted on the Pink Sheets do not have to be Exchange Act reporters or banking or insurance reporters. Moreover, in the case of a non-reporting company, the information available to investors may be quite limited because Rule 15c2-11[151] only requires a broker-dealer to have a small amount of information (despite recent Commission attempts to expand Rule 15c2-11[152]). As such, the Commission has observed:

> With the exception of a few foreign issuers, the companies quoted in the Pink Sheets tend to be closely held, extremely small and/or thinly traded. Most do not meet the minimum listing requirements for trading on a national securities exchange . . . . Many of these companies do not file periodic reports or audited financial statements with the SEC, making it very difficult for investors to find reliable, unbiased information about those companies. For all of these reasons, companies quoted in the Pink Sheets can be among the most risky investments. That's why you should take extra care to thoroughly research any company quoted exclusively in the Pink Sheets. Be aware that some broker-dealers are required by [SEC] Rule 15c2-11 . . . to have some information about the issuer. Ask your broker-dealer whether it has any Rule 15c2-11 information before you invest.[153]

Rule 15c2-11 requires a broker-dealer to have in its records the "paragraph (a) information" specified in the rule before it publishes any quotation for the issuer's security in any quotation medium other than a national securities

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148. Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Order Granting Approval of Proposed Rule Change and Amendment No. 1 To Be Proposed Rule Change by the National Association of Securities Dealers, Inc. Relating to Microcap Initiatives-Amendments to NASD Rules 6530 and 6540, Exchange Act Release No. 34-40878, 64 Fed. Reg. 1255, 1256 (Jan. 8, 1999).

149. *Id.*

150. *Id.* at 1257.

151. 17 C.F.R. § 240.15c2-11 (2005).

152. *See infra* notes 318-47 and accompanying text.

153. Securities and Exchange Commission, Pink Sheets, http://www.sec.gov/answers/pink.htm (last visited Jan. 5, 2006).

exchange or NASDAQ.[154] Further, the broker-dealer must, based upon a review of that information along with any other documents and information required by subsection (b) of Rule 15c2-11, have a "reasonable basis under the circumstances" for believing that the information is "accurate in all material respects" and that the sources of the information are reliable.[155] For a private issuer that has not filed a Securities Act registration statement within the past ninety days or a Regulation A offering statement[156] within the last forty days,[157] the paragraph (a) information includes: (1) "the nature of the issuer's business"; (2) "the nature of products or services offered"; (3) "the nature and extent of the issuer's facilities"; (4) the names of the CEO and directors; and (5) "the issuer's most recent balance sheet and profit and loss and retained earnings statements" and "similar financial information for such part of the [two] preceding fiscal years as the issuer or its predecessor has been in existence."[158]

This information obviously pales in comparison to the extensive disclosures required by the Exchange Act. For example, although some financial statements are required, they need not be audited, reviewed, or even compiled by an accounting firm, let alone an accounting firm that meets the Exchange Act's independence requirements.[159] Similarly, the requirements of information concerning "the nature of the issuer's business" and "the nature of products or services offered" are quite vague when compared to extensive, specific disclosures required by Item 101 of Regulation S-K to be included in Forms 10-

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154. 17 C.F.R. § 240.15c2-11. Although Pink Sheets is a "quotation medium" within the meaning of Exchange Act Rule 15c2-11(e)(1), the rule does not apply to securities that are listed on an exchange or quoted on NASDAQ. *See* Publication or Submission of Quotations Without Specified Information, Exchange Act Release No. 34-39670, 63 Fed. Reg. 9661, 9661 (Feb. 25, 1998) (to be codified at 17 C.F.R. pt. 240), 1998 WL 74890 [hereinafter 1998 Release].

155. 17 C.F.R. § 240.15c2-11(b).

156. *See generally* 17 C.F.R. §§ 230.251-.263 (2005).

157. *See* Exchange Act Rule 15c2-11(a)(1), (2)-(3), 17 C.F.R. § 240.15c2-11(a)(2).

158. Exchange Act Rule 15c2-11(a)(5), *id.* § 240.15c2-11(a)(5). More mundane information is also required, such as the issuer's name, address and state of incorporation, the exact title and class of the security and its par value, and

> whether the quotation is being submitted or published directly or indirectly on behalf of the issuer, or any director, officer or any person, directly or indirectly the beneficial owner of more than 10 percent of the outstanding units or shares of any equity security of the issuer, and, if so, the name of such person, and the basis for any exemption under the federal securities laws for any sales of such securities on behalf of such person.

*Id.* Subsection (b) requires that the broker-dealer possess (1) a record of the circumstances involved submitting the quotation, (2) certain information relating to any trading suspension order issued by the Commission with respect to any securities of the issuer or a predecessor during the past twelve months, and (3) "any other material information (including adverse information) regarding the issuer which comes to the broker's or dealer's knowledge or possession before the publication or submission of the quotation." Exchange Act Rule 15c2-11(b), *id.* § 240.15c2-11(b).

159. *See generally supra* notes 39-41 and accompanying text.

K.[160] Further, Rule 15c2-11 does not apply to an unsolicited quotation (i.e., a quotation "solely on behalf of a customer . . . that represents the customer's indication of interest and does not involve the solicitation of the customer's interest"), subject to some qualifications.[161]

The "paragraph (a)" information must be made "reasonably available upon request to any person expressing an interest in a proposed transaction in the security" with the broker-dealer.[162] Due to the rule's "piggyback" provision,[163] however, it may be difficult for an investor actually to get the information. As the Commission observed in 1998: "This requirement may have little practical effect because only the first broker-dealer to publish quotations must have the information, and an investor might find it difficult to identify that broker-dealer. In fact, that broker-dealer may no longer be publishing quotations."[164] Although the piggyback exception is based on the premise that "regular and frequent quotations for a security generally reflect market supply and demand and are based on independent, informed pricing decisions," the effect of the exception is that the rule "is essentially limited to just the first broker-dealer publishing quotes."[165] The result is that Rule 15c2-11 is badly flawed because neither the investor nor the registered representative of the broker-dealer will possess the required information in most instances.[166] Moreover, even if the piggyback exception does not apply, the investor will receive the information only if he or she asks for it.

Just as the content of paragraph (a) information is paltry compared to the information required of Exchange Act reporters, its timeliness could lag far behind that required of Exchange Act reporters. As discussed above, Forms 10-K (which contain annual financial statements) must be filed within ninety days after an issuer's fiscal year and even sooner for accelerated filers.[167] Similarly, Forms 10-Q are due within forty-five days after the quarter, and sooner for accelerated filers.[168] By contrast, paragraph (a) information is only required to

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160. 17 C.F.R. §§ 229.101, 249.310 (2005).

161. Exchange Act Rule 15c2-11(f)(2), 17 C.F.R. § 240.15c2-11(f)(2).

162. Exchange Act Rule 15c2-11(a)(5), *id.* § 240.15c2-11(a)(4).

163. *See infra* note 322 and accompanying text.

164. 1998 Release, *supra* note 154, at 9669.

165. Publication or Submission of Quotations Without Specified Information, Exchange Act Release No. 34-41110, 64 Fed. Reg. 11,124, 11,126 (Mar. 8, 1999) (to be codified at 17 C.F.R. pt. 240) [hereinafter 1999 Release].

166. As R. Cromwell Coulson of Pink Sheets, LLC, stated in a June 10, 2005, letter to the Commission, "the quoting broker-dealer is commanded by regulation to stuff the information into its files where, in all likelihood, it will never again see the light of day. Rule 15c2-11 is a rule of darkness." Letter from R. Cromwell Coulson, CEO, Pink Sheets, LLC, to Jonathan Katz, Secretary, Securities and Exchange Commission (June 10, 2005), *available at* http://www.sec.gov/rules/other/265-23/pinksheets061005.pdf [hereinafter Coulson 2005 Letter].

167. *See supra* notes 81-84 and accompanying text.

168. *See supra* notes 81-84 and accompanying text.

be "reasonably current."[169]

Paragraph (a) financial statements are generally presumed reasonably current if the balance sheet is less than sixteen months old at the time of the quotation and the statements of profit and loss and retained earnings are for the twelve months preceding the balance sheet date.[170] If the balance sheet is six months or more old, the broker-dealer must also have statements of profit and loss and retained earnings for the period from the date of the balance sheet to a date within six months.[171] With respect to other "paragraph (a)" information, it is generally presumed reasonably current if it is less than twelve months old.[172] The end result is that Rule 15c2-11 information, although considered "reasonably current," could be much, much older than Exchange Act information. For example, balance sheets could be up to sixteen months old and income statements (i.e., profit and loss statements) could be up to six months old.

*3. Pink Sheets Disclosure Policy.*—In an apparent effort to make more information about its issuers publicly available, the Pink Sheets recently adopted a disclosure policy ("Disclosure Policy").[173] Although the actual text of the Disclosure Policy does not so indicate, it is only applicable to companies that have securities quoted on the Pink Sheets on an unsolicited basis[174] and that have not previously had securities listed on an exchange or quoted on the OTCBB.[175] Nevertheless, the "Pink Sheets encourages all issuers to make this information available to the public."[176]

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169. Exchange Act Rule 15c2-11(a)(5), 17 C.F.R. § 240.15c2-11(a)(s) (2005).

170. *Id.* § 240.15c2-11(g)(1).

171. *Id.*

172. *Id.* § 240.15c2-11(g)(2).

173. Pink Sheets, Guidelines for Providing Adequate Current Information Pursuant to Rule 15c2-11 (Version 5.5, Dec. 29, 2005), http://www.pinksheets.com/otcguide/15c2-11_guidelines.pdf [hereinafter Disclosure Policy]. When it was first adopted in October 2004, it was only effective for companies whose securities would thereafter be quoted on the Pink Sheets. In February 2005, however, the Pink Sheets extended the Disclosure Policy to companies whose securities were quoted before October 2004. E-mail from Liz Heese, Issuer Services, Pink Sheets, LLC, to Michael K. Molitor, Assistant Professor of Law, Thomas M. Cooley Law School (Feb. 25, 2005, 08:01 EST) (on file with author).

174. This would mean that the informational requirements of Exchange Act Rule 15c2-11 are not applicable. *See supra* note 161 and accompanying text.

175. Press Release, Pink Sheets, LLC, New Disclosure Policy Effective February 15th for Issuers of Securities Quoted on an Unsolicited Basis (Feb. 15, 2005), *available at* http://www.pinksheets.com/about/pr_021405.jsp. It is unclear whether this would include securities that had been listed on NASDAQ. Perhaps the Pink Sheets meant to include NASDAQ within the meaning of an exchange in this context, particularly since NASDAQ requires issuers to meet listing requirements but the OTCBB does not.

176. *Id.* This press release continues:

> If an issuer is quoted on an unsolicited basis, this means that the NASD has not cleared a market maker to enter a quote in the security pursuant to SEC Rule 15c2-11. Instead, a broker is relying on an exemption to the rule . . . . This exception has been used to

In addition, the Disclosure Policy indicates that the specified information must be available in four situations: (1) at the "time of initial quotation in the public markets," (2) when the issuer's insiders or affiliates are offering, buying or selling its securities, (3) when the issuer or affiliates are engaged in "promotional activities having the effect of encouraging trading of the issuer's securities," and (4) when securities initially sold in a private placement (i.e., restricted securities) become freely tradable.[177] As such, not all Pink Sheets issuers would be subject to the Disclosure Policy. For example, an issuer whose securities were once traded on NYSE but which determined to delist would not be subject to this policy because its securities were once listed on a securities exchange—no matter how long ago.[178] Moreover, other issuers would be subject to it only in the four situations described above.

The Disclosure Policy begins with a series of "general considerations," one of which is that investors "should be provided with all 'material' information—the information . . . necessary to make a sound investment decision. The disclosure should enable an investor of ordinary intelligence and investment skills to understand the issuer's business and prospects."[179] To this end, the required disclosure should "generally" be less than ninety days old[180] and include "the issuer's business plan—a full and clear picture of the issuer's assets, facilities, properties, investments, management and other resources as well as a complete description of how they will be used to make profits."[181]

The required contents of the Disclosure Policy are divided into two parts. The first essentially parallels, and elaborates to some extent, the requirements of Rule 15c2-11.[182] The second part essentially mimics the required disclosures on Form 8-K by requiring the issuer to issue a press release within ten business days

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> trade securities of new issuers without any disclosure to the investing public. To address this situation, in October 2004, Pink Sheets revised our policy for brokers entering unsolicited quotes in a new security that has never been listed on an exchange or quoted on the OTCBB. We now require that prior to publication of an unsolicited quote in the Pink Sheets for such securities; the broker must ascertain that the issuer has made adequate current information publicly available on www.pinksheets.com. The information disclosure policy has been very successful at creating transparency of the basic information that investors trading in public markets deserve.
>
> Pink Sheets is now extending the information disclosure policy to the issuers of securities in which unsolicited quotes were entered into the Pink Sheets prior to October 2004.

*Id.*

177. Disclosure Policy, *supra* note 173, at 1.

178. Exchange Act Rule 15c2-11 would apply, however.

179. Disclosure Policy, *supra* note 173, at 1.

180. *Id.*

181. *Id.*

182. *Id.* at 2-11; *see* 17 C.F.R. § 240.15c2-11 (2005). The Pink Sheets Disclosure Policy does not require information with respect to subsections (a)(5)(xiv) and (xv) of Rule 15c2-11.

after various events, as discussed below.[183]

In its counterpart to Rule 15c2-11's requirement of information about the "nature of the issuer's business," the Disclosure Policy requires that the issuer discuss material events during the past three years.[184] Enumerated material events include bankruptcy or similar proceedings; material business combination transactions or any "purchase or sale of a significant amount of assets"; financing defaults; changes in control; recapitalizations, stock splits, and similar events; delisting of the company's securities from an exchange, NASDAQ, or the OTCBB; and any proceedings that could have a material effect on the issuer.[185] The Disclosure Policy requires the issuer to describe its business "so a potential investor can clearly understand it" and, "to the extent material to an understanding of the issuer," disclose matters such as affiliated companies, the "effect of existing or probable governmental regulations on the business," costs of environmental law compliance, and research and development expenditures.[186] The issuer must also disclose information about its investment policies, particularly with respect to real estate.[187]

The portion of the Disclosure Policy that parallels Rule 15c2-11's requirement of information about the "nature of products or services offered," requires disclosure of the following items "so that a potential investor can clearly understand the products and services of the issuer": the issuer's products or services and their markets; its distribution methods; "competitive business conditions, the issuer's competitive position in the industry, and methods of competition"; the availability of raw materials; the issuer's dependence on major customers; intellectual property matters; and whether any government approvals are required.[188]

Rule 15c2-11 simply requires the names of the issuer's CEO and directors.[189] However, the Pink Sheets Disclosure Policy greatly expands on this by requiring such information as employment histories for the past ten years, board memberships and "other affiliations" of not just the CEO and board members, but also many other related persons.[190] Furthermore, the issuer must disclose

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183. Disclosure Policy, *supra* note 173, at 12-21; *see* 17 C.F.R. § 249.308 (2005). *See generally infra* notes 267-71 and accompanying text.

184. Disclosure Policy, *supra* note 173, at 3; *see* 17 C.F.R. § 240.15c2-11(a)(5)(viii).

185. Disclosure Policy, *supra* note 173, at 3-4.

186. *Id.* at 4-5.

187. *Id.* at 5.

188. *Id.* at 5-6; *see* 17 C.F.R. § 240.15c2-11(a)(5)(ix).

189. 17 C.F.R. § 240.15c2-11(a)(5)(ix).

190. Disclosure Policy, *supra* note 173, at 7. The Disclosure Policy notes that the "goal of this section is to provide an investor with a clear understanding of the identity of all the persons or entities are that are involved in managing, controlling or advising the operations, business development and disclosure of the issuer, as well as the identity of any significant shareholders." *Id.* These persons could include executive officers, directors, general partners, investment bankers, promoters, control persons, legal counsel, accountants or auditors, public relations consultants, and "[any] other advisor(s) that assisted, advised, prepared or provided information with respect to this

whether any of these persons were involved in certain "bad boy" legal proceedings within the last five years.[191] For the issuer's accountant or auditor, the disclosure should "describe the responsibilities of the accountant and the responsibilities of management (i.e. who audits, prepares or reviews the issuer's financial statements, etc.)."[192]

Rule 15c2-11 requires the issuer's most recent balance sheet and profit and loss and retained earnings statements and "similar financial information for such part of the two preceding fiscal years as the issuer or its predecessor has been in existence."[193] The Pink Sheets Disclosure Policy adds to this in a number of respects. First, it requires that the financial statements be prepared in accordance with GAAP.[194] Second, it requires not just a balance sheet and income statement, but also statements of cash flows and changes in stockholders' equity and notes to the financial statements.[195] Third, these financial statements "should" be provided for the most recent fiscal year and any interim quarters.[196] Annual financial statements won't be considered "current" more than ninety days after the end of the following fiscal year; quarterly financial statements will not be considered "current" more than forty-five days after the end of the following quarter. Most importantly, however, the Disclosure Policy also notes that

> financial statements should either be audited or contain a certification by the chief financial officer of the issuer, or any other person responsible for the preparation of such statements, that such statements, and the notes thereto, present fairly, in all material respects, the financial position of the issuer and the results of its operations and cash flows for the periods presented, [in accordance with GAAP].[197]

Again, the Pink Sheets should be commended for taking this important step, particularly since it was under no obligation to do so. However, the Disclosure Policy contains serious flaws, both in terms of which issuers are subject to it and in terms of the information that it requires. These concerns are discussed in Part III below, which also presents several suggestions for an alternative approach.

## II. How to Go (or Stay) Private

### *A. In General*

Obviously, the Exchange Act imposes extensive disclosure obligations.

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disclosure documentation." *Id.* at 8.

191. *Id.* at 8-9. These provisions appear loosely based on Item 401(f) of Regulation S-K, 17 C.F.R. § 229.401 (2005).

192. Disclosure Policy, *supra* note 173, at 8.

193. 17 C.F.R. §§ 240.15c2-11(a)(5)(xii), (xiii).

194. Disclosure Policy, *supra* note 173, at 10.

195. *Id.* at 9.

196. *Id.*

197. *Id.* at 10.

Moreover, from the standpoint of the issuer's compliance team, the demands for disclosure and substantive conduct controls have increased substantially in recent years and show few signs of lessening in the future. It is thus not surprising that many public companies decided to go private after SOX.[198] Moreover, it is possible that the number of companies going private could substantially increase in the future as the magnitude of costs relating to SOX, particularly the Section 404 internal controls report, become more widely appreciated.[199]

In this Article, "going private" or "going dark" refers to the situation where an Exchange Act reporting issuer terminates its reporting obligations by deregistering its securities under Sections 12(b) or (g) of the Exchange Act. This usually also involves the issuer's securities being delisted from an exchange or NASDAQ. But this does not necessarily mean that the issuer's securities will stop trading in all securities markets; indeed, many former Exchange Act companies have moved to the Pink Sheets to maintain a trading market for their securities.[200]

As such, laypeople may think that such a "dark" issuer is still a "true" public company because investors may purchase its securities in much the same manner they may purchase securities of Exchange Act reporters. However, the information that such an issuer is required to make public is dramatically less than what is required of Exchange Act reporters; thus, shareholders of issuers that have gone dark are at an extreme disadvantage in terms of their ability to access information about their investments. Although Part III of this Article examines some approaches for remedying this situation, it is helpful first to review how easily a public company can go private.

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198. There are many good reasons to go private. It eliminates the expenses (e.g., accounting and legal fees) and management time involved in preparing Exchange Act reports. It also results in more privacy, as the issuer no longer must disclose the information required by the Exchange Act, much of which could be sensitive from a competitive standpoint. Going private also permits management to focus more attention on running the company, rather than on short-term concerns like stock prices. But going private can create disadvantages. The most obvious disadvantage is that, even if the issuer's securities are quoted on the Pink Sheets, they will probably be less "liquid" than when traded on an exchange or NASDAQ. Academic literature indicates that this loss of liquidity results in a decline in the value of the securities. *See generally infra* notes 232-41 and accompanying text. For a discussion of the economic consequences to issuers that are involuntarily delisted from an exchange or NASDAQ and whose securities are subsequently traded in an OTC market, see JONATHAN MACEY ET AL., DOWN AND OUT IN THE STOCK MARKET: THE LAW AND FINANCE OF THE DELISTING PROCESS (Nov. 2003, revised Mar. 2004), http://www.haas.berkeley.edu/finance/delistings%20-%20Mar04%20draft.pdf. Also, no longer being public will likely make it more difficult for the issuer to raise additional capital in securities offerings; borrow on favorable terms; or attract and retain personnel by using publicly traded stock, or options to acquire such stock, as a compensation device.

199. *See supra* notes 7-8 and accompanying text.

200. *See supra* notes 145-47 and accompanying text.

### *B. How to Terminate Exchange Act Reporting Obligations*

If an issuer decides to go private, the exact process will depend on the nature of its shareholder base. A Section 12(g) registrant can deregister once there are fewer than 300 record shareholders of the registered class of securities.[201] As such, if an issuer that wishes to go private has more than 300 record shareholders, it must reduce this number below 300,[202] often by taking steps to "cash out" some shareholders.[203]

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201. *See supra* notes 32-33 and accompanying text. Some practitioners refer to this rule as "500 going up, 300 coming down." In some cases, "500 coming down" may be applicable. See *supra* note 32 for a discussion of Exchange Act Rule 12g-4, 17 C.F.R. § 240.12g-4 (2005).

202. From a practical standpoint, such an issuer should reduce the number of record shareholders far below 300, so as to guard against later becoming subject to the Exchange Act's reporting requirements by having more than 500 shareholders of record. As discussed above, many shares are held in "street name," which means that the number of record holders may be far below the number of beneficial holders. *See supra* notes 26-30 and accompanying text. After going private, those beneficial holders may request stock certificates for their shares, thereby becoming record shareholders. In sufficient numbers, this could cause the issuer to again cross the 500 record-shareholder threshold of Section 12(g).

203. Many devices may be used to eliminate a sufficient number of shareholders. *See generally* FRANKLIN A. GEVURTZ, CORPORATION LAW 729-32 (West Group 2000). For example, the issuer could engage in a reverse stock split, issuing one share in exchange for a number of shares calculated to eliminate enough shareholders to get below 300 record shareholders. If the split ratio chosen were say, 1-for-100, then each shareholder that owns 100 shares would receive one new share in exchange for his currently outstanding 100 shares. Shareholders with fewer than 100 shares would not receive new shares; instead, their shares would be redeemed for cash at a predetermined price, leaving them with no equity interest in the company and thus reducing the number of shareholders. Similarly, the issuer could engage in a merger with a newly formed entity, the terms of which provide that the issuer's shareholders would receive cash for their shares while the owners of the new company—typically insiders of the issuer—would continue to own shares in the surviving entity. Another method is an issuer tender offer, whereby the issuer would offer to redeem its outstanding shares for cash. Tender offers could also be made by newly formed entities owned by insiders. Under Exchange Act Rule 13e-3, 17 C.F.R. § 240.13e-3, some of these transactions will require the issuer to file a Schedule 13E-3 if they have a reasonable likelihood or a purpose of causing any class of equity securities that is subject to Sections 12(g) or 15(d) of the Exchange Act to be held of record by fewer than 300 persons or causing any class of equity securities that is listed on a securities exchange or NASDAQ to no longer be listed. In addition, Exchange Act Rule 13e-4 requires that issuers that make tender offers for their own securities must make disclosures to their security holders that are substantially similar to the information that is required under Exchange Act Section 14(d) when a third party makes a tender offer for the securities. This information is normally contained in a Schedule TO that must be filed with the Commission. *See* General Instruction J to Schedule TO, 17 C.F.R. § 240.14d-100.

If a transaction is needed to reduce the number of record shareholders below 300 and the transaction will involve insiders remaining as equity holders, there are at least three more issues to be considered. Although these issues are beyond the scope of this Article, a few words about them

For issuers who are already below the 300-record-shareholder threshold, no such transaction is necessary. Going private in this situation involves two considerations. First, if the issuer's securities are listed on a securities exchange or NASDAQ, the issuer will need to abide by that organization's requirements to delist those securities. Second, it must follow the Commission's requirements in this area. These requirements are neither difficult nor time-consuming.[204]

*1. Voluntarily Delisting From NYSE.*[205]—The NYSE Listed Company Manual simply provides that an issuer may delist a security from NYSE after its board approves the action and the issuer furnishes NYSE with a certified copy of the board resolution.[206] Thereafter, the issuer may file an application with the Commission to withdraw the security from listing on NYSE and from registration under the Exchange Act.

*2. Commission Requirements for Voluntarily Delisting from an Exchange and Deregistering Under Section 12(b).*—Until recently, Exchange Act Rule 12d2-2(d) provided that the issuer of a security listed on a national securities exchange could file an application with the Commission to withdraw the security

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are in order. First, the applicable "appraisal rights" statute must be consulted because it may allow minority shareholders to demand the "fair value" of their shares if they must vote on the transaction. *See, e.g.*, MODEL BUS. CORP. ACT § 13.02 (1984). Second, there is a considerable body of case law concerning the rights of minority shareholders in "freeze-out" mergers and similar transactions. *See* GEVURTZ, *supra*, at 733-43. This means that the insiders may need to demonstrate that the issuer had a "business purpose" for the transaction and that it engaged in "fair dealing" and offered a "fair price" for the minority's shares. Finally, some states have anti-takeover legislation that may, among other things, limit the ability of an "interested" shareholder to engage in a transaction with the issuer within a specified period of time. *See, e.g.*, DEL. CODE ANN. tit. 8, § 203 (2005).

204. *See* David Alan Miller & Marci J. Frankenthaler, *Delisting/Deregistration of Securities Under the Securities Exchange Act of 1934*, INSIGHTS, Oct. 2003, at 7 ("An Exchange Act registered company with less than 300 record holders that wants to 'go private' need not engage in a complex, time consuming and expensive 'going private' transaction to avoid the costs of periodic reporting and compliance with Sarbanes-Oxley.").

205. Although there are several securities exchanges, this section considers only NYSE's delisting requirements. As a technical matter, because NASDAQ currently is not an "exchange," securities listed on it are registered under Section 12(g) rather than Section 12(b). *But see supra* note 16. NASDAQ allows an issuer to terminate its listing by written notice. NASDAQ Marketplace Rules, *supra* note 133, § 4480(b). The OTCBB does not have any formal procedures for delisting. *See* Miller & Frankenthaler, *supra* note 204, at 10.

206. NYSE, Inc., Listed Company Manual, *supra* note 16, § 806.02. This rule was amended in October 2003. At the same time, former NYSE Rule 500 was repealed. Previously, Rule 500 had required approval of a delisting decision by both the board and the audit committee, as well as the issuance of a press release and notice to the issuer's thirty-five largest institutional shareholders. The delisting would not be effective until at least twenty or up to sixty days after the date of the press release or the shareholder notice, whichever was later. Before 1999, Rule 500 had also required shareholder approval of a delisting decision. Board approval will always be required for such a major change in the company's status. Under the new rule, shareholder approval is not required, except where the issuer's charter documents provide otherwise.

from listing.[207] The Commission would then publish notice of the filing in the *Federal Register*, and the notice would allow any interested party to submit to the Commission "all facts bearing upon . . . what terms should be imposed by the Commission for the protection of investors."[208] However, the Commission "rarely receive[d] comments on issuer withdrawal applications."[209] Also, although the Commission could have imposed terms on a delisting for the protection of investors, it rarely did so.[210] If the Commission approved the application after the comment period, typically twenty-one days,[211] it issued an order delisting the securities.

In July 2005, the Commission adopted changes to Rule 12d2-2 designed to "streamline" the process of delisting securities from an exchange and removing them from Section 12(b) registration.[212] For voluntary delisting applications, the issuer now must file a Form 25[213] with the Commission via EDGAR[214] to notify the Commission that a class of its securities has been delisted from an exchange and that it intends to deregister that class under Section 12(b). However, at least ten days before filing the Form 25 with the Commission, the issuer must notify the exchange of its intent to withdraw the security from listing and

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207. 17 C.F.R. § 240.12d2-2 (2004) (as amended in 2005). Rule 12d2-2 also specifies the methods by which an exchange may delist a security where, for example, the security no longer meets the exchange's listing criteria. However, this section focuses on a situation where the issuer is applying to voluntarily delist its securities from the exchange.

208. *Id.* § 240.12d2-2(d).

209. Removal from Listing and Registration of Securities Pursuant to Section 12(d) of the Securities Exchange Act of 1934, Exchange Act Release No. 34-49858, 69 Fed. Reg. 34,860, 34,861 (proposed June 22, 2004) (to be codified at 17 C.F.R. pts. 232, 240, and 249). The Commission noted that it received one comment on a delisting application in 2003, three in 2002, and none in 2001. *Id.* at 34,865 n.66. In a later Release, the Commission noted that it had received two comments on delisting applications in 2004 and two comments to date in 2005. Removal from Listing and Registration of Securities Pursuant to Section 12(d) of the Securities Exchange Act of 1934, Exchange Act Release No. 34-5202, 70 Fed. Reg. 42,456, 42,457 n.12 (July 22, 2005) (to be codified at 17 C.F.R. pts. 232, 240, and 249).

210. Removal from Listing and Registration of Securities Pursuant to Section 12(d) of the Securities Exchange Act of 1934, 69 Fed. Reg. at 34,865 n.66 ("[T]he Commission has not in recent years, imposed any conditions on the delisting applications it approved.").

211. Miller & Frankenthaler, *supra* note 204, at 10.

212. Removal from Listing and Registration of Securities Pursuant to Section 12(d) of the Securities Exchange Act of 1934, 70 Fed. Reg. at 42,456. The changes will become operative on April 24, 2006.

213. Before these amendments, Form 25 was only required to be filed by exchanges, not issuers, in certain delisting situations. *See* Exchange Act Rule 12d2-2(a), 17 C.F.R. § 240.12d2-2.

214. Before these changes, Exchange Act Rule 12d-2 did not require EDGAR filings of delisting applications, although it appears to have been a common practice for issuers that proposed to voluntarily delist their securities to issue press releases to that effect. Also, Item 3.01(d) of Form 8-K (added in March 2004) requires disclosure of board actions that may cause securities to be listed from an exchange or NASDAQ. 17 C.F.R. § 249.308 (2005).

contemporaneously publish notice of its intentions via a press release and by a posting on its website (if it has one).[215] Also, if the issuer has not arranged for listing and/or registration on another exchange or for quotation of its securities in a quotation medium such as the Pink Sheets, the press release and website posting must so indicate.[216]

Under the amended rule, the delisting would become effective ten days after the Form 25 is filed with the Commission, whereas the removal of the securities from registration under Section 12(b) of the Exchange Act would not become effective until ninety days after the filing (although the Commission could impose a shorter time period).[217] However, the amended rule would allow the Commission to delay these dates if necessary to protect investors.[218] As the Commission stated in 2004 when it proposed revisions to Rule 12d2-2, these amendments will "reduce uncertainty to issuers, exchanges, and the public as to the timing and status of a security because delisting and deregistration would be accomplished by the electronic filing of revised Form 25, instead of by Commission order."[219]

The Commission is correct that the revised process will provide more notice to investors, particularly by requiring an electronic filing and press release. Moreover, investors will know more precisely when the delisting will occur. However, it appears the Commission does not view delisting as terribly problematic for most contemporary investors. The Commission observed in its 2004 proposal that Rule 12d2-2 was adopted at a time

> when delisting from an exchange had broad ramifications for shareholders, because of the lack of alternative markets. . . . While delisting can still have a major impact on an issuer and its shareholders, under the current market structure, delisting on one market does not necessarily mean that shareholders would be unable to trade an issuer's securities in another market environment.[220]

Nonetheless, a former Exchange Act reporting company shareholder whose securities are now traded in a market "environment" that does not require

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215. 17 C.F.R. §§ 240.12d2-2(c)2(ii), (iii). This posting must remain available until the delisting becomes effective. Subsection (c)(3) of the amended rule would require the exchange to post notice of receiving this information from the issuer on its website by the next business day.

216. *Id.*

217. *See* Exchange Act Rule 12d2-2(d)(1)-(2), *id.* § 240.12d2-2(d)(1)-(2). Subsection (d)(5) of the amended rule provides that the issuer's duty to file reports under Section 13(a) of the Exchange Act would typically be suspended upon the effectiveness of the delisting, even though the deregistration would not take effect until later. *Id.* § 240.12d2-2(d)(5).

218. *See* Exchange Act Rule 12d2-2(d)(3), *id.* § 240.12d2-2(d)(3).

219. Removal from Listing and Registration of Securities Pursuant to Section 12(d) of the Securities Exchange Act of 1934, Exchange Act Release No. 34-49858, 69 Fed. Reg. 34,859, 34,862 (proposed June 22, 2004) (to be codified at 17 C.F.R. pts. 232, 240, and 249) (footnote omitted).

220. *Id.* at 34,861.

Exchange Act reporting would likely argue that this change has had "broad ramifications."

*3. Voluntary Deregistration Under Section 12(g).*—For an issuer with fewer than 300 record shareholders, deregistering under Section 12(g) is very easy: simply file a Form 15[221] with the Commission. This one-page form requires the issuer to specify the rule under which it is deregistering. This will often be Exchange Act Rule 12g-4(a)(1)(i), which allows for terminating the registration of a class of securities if the class is held by fewer than 300 record holders.[222] Although the deregistration typically is not effective for ninety days, Rule 12g-4(b) provides that the issuer's duty to file periodic Exchange Act reports is usually suspended immediately.[223]

## III. WHAT SHOULD BE REQUIRED OF NON-REPORTING PINK SHEETS ISSUERS?

### *A. Why Require Information?*

It goes without saying that the federal securities laws are largely[224] designed to ensure the flow of information about issuers to investors in the capital markets, whether in the context of a public offering of securities, as under the Securities Act, or on an ongoing basis, as under the Exchange Act. Many provisions can be seen as attempts to bolster public confidence in the capital markets and to level the playing field among investors.[225] As commentators have observed,

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221. 17 C.F.R. § 249.323 (2005).

222. 17 C.F.R. § 240.12g-4. For the corresponding rule to suspend the duty to file reports required by Section 15(d) of the Exchange Act, see Exchange Act Rule 12h-3(b)(1)(i), *id.* § 240.12h-3.

223. See *supra* note 205 for a discussion of how an issuer delists its securities from NASDAQ.

224. Commentators note that with SOX "Congress departed radically from its historical preoccupation of addressing investor protection via disclosure." JAMES D. COX ET AL., SECURITIES REGULATION 9 (4th ed. 2004).

225. One former Commissioner asked us to imagine:

> if each investor needed to decide for himself what disclosure was desirable and separately contracted for liability protection. The result would be . . . expensive chaos. Ultimately, investors would seek a system similar to what now exists with standard agreements, customary arrangements, and general terms and conditions. Anything else would be unworkable. Moreover, there are some investors who would not be able to contract very well, and because our society to a fair degree does care about others, legislation or rules would be enacted to protect the less sophisticated from those who would take advantage of them. Under our current regulatory structure, the result is that the SEC seeks, and imposes through regulation, what would be the collective contract of many disaggregated investors if there were an efficient mechanism for each to contract separately and well. In this manner, the SEC can be viewed as the collective bargaining agent for investors . . . .

Steven M. H. Wallman, *Competition, Innovation, and Regulation in the Securities Markets*, 53 BUS. LAW. 341, 351-52 (1998).

Congress settled on disclosure instead of substantive regulation in an attempt to prevent a repetition of the disastrous stock market abuses of the early twentieth century.[226] Although this disclosure approach is firmly embedded in securities law despite ongoing academic criticism,[227] a few words about some of its primary justifications are warranted.

One argument for mandatory disclosure is that information about issuers is useful to all market participants. Without mandatory disclosure, there would be wasteful duplication of efforts, as many market participants worked to uncover the same information about the same issuers. Requiring disclosure eliminates this problem to a large degree.

Another justification is that management of the issuer has an interest in disclosing (and emphasizing) good news about the issuer and suppressing bad news, and thus only would disclose favorable information without specific reporting obligations.[228] Although some have argued that market forces would lead some, if not most, issuers to voluntarily adopt an evenhanded disclosure policy to gain the market's confidence,[229] the prevailing view is that this carrot would not work without a stick (the threat of Commission enforcement and civil liability). The recent deluge of Commission enforcement cases concerning fraudulent disclosures or omissions supports this view. A related justification is that required disclosures allow shareholders to better monitor management's performance, thereby promoting the efficient allocation of capital to companies that perform well and away from companies that do not.[230]

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226. *See, e.g.*, COX ET AL., *supra* note 224, at 3.

227. *See generally* 1 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 179-223 (3d ed., rev. vol. 1998) (discussing and summarizing arguments for and against mandatory disclosure under federal securities laws); Sharon Hannes, *Comparisons Among Firms: (When) Do They Justify Mandatory Disclosure?*, 29 J. CORP. L. 699, 704-08 (2004) (same). Two well known law review articles addressing this topic are Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669 (1984) and John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717 (1984).

228. Conversely, management could selectively release bad news for the purpose of driving down the price of the issuer's securities and then buying them at a discount.

229. 1 LOSS & SELIGMAN, *supra* note 227, at 187-89 ("In theory, it can be argued that a mandatory corporate disclosure system is unnecessary because corporate managers possess sufficient incentives to disclose voluntarily all or virtually all information material to investors. . . . [M]anagement in theory will seek to establish a reputation for honest and full disclosure in order to preserve its ability to sell securities in the new issues market." (footnotes omitted)).

230. *See, e.g.*, Donald C. Langevoort, *Information Technology and the Structure of Securities Regulation*, 98 HARV. L. REV. 747, 763-64 (1985) ("A primary objective of securities regulation is to promote informed investment decisions. When a person is confident that the information he possesses about the value of a security is complete and materially accurate, he either will be more willing to place capital at risk or will demand less compensation for assuming the risk. Because increased access to information facilitates capital formation and thus furthers economic growth, there is a prima facie justification for government intervention to promote that end." (footnotes

Fraud prevention is another reason to require disclosure.[231] With much less information available about non-reporting Pink Sheets issuers compared to Exchange Act issuers, one might expect a higher incidence of fraud involving Pink Sheets securities. Indeed, the lower rungs of the OTC market have long been regarded as dangerous for investors. As the report of the Twentieth-first Annual SEC Government-Business Forum on Small Business Capital Formation stated regarding NASDAQ's then-current plan to replace the OTCBB with the Bulletin Board Exchange ("BBX"):

> The stock of many companies that currently trade on the OTCBB may become forced to trade in the Pink Sheets due to the inability of the

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omitted)).

231. 1 LOSS & SELIGMAN, *supra* note 227, at 193 ("The mandatory corporate disclosure system was adopted because of widely held beliefs that securities fraud was prevalent and that state laws often could do little to prevent or punish it." (footnote omitted)). One common form of fraud involves the use of "shell companies," or companies with little or no operations and assets. As the Commission recently explained in a release proposing to prevent shell companies from using Securities Act Form S-8, the classic "pump and dump" scheme involving a shell company typically includes the following factors:

> the shell company promoters issue large amounts of securities to themselves or designated nominees, sometimes using Form S-8; [t]he shell company acquires or is merged with a private business that the promoters claim has high growth potential; [i]nadequate information is available to investors regarding the post-transaction company; [t]he promoters "pump" up the price of the stock to investors through unduly positive press releases on the company and its prospects, exaggerated tout sheets, or fraudulent messages on the Internet; [t]he promoters use high-pressure tactics to get people to invest, and also engage in market manipulation to create artificial demand and artificially high prices for the stock of the company; and [t]he promoters "dump" their stock in the company by selling it at the artificially high prices their promotional activities have created, halt those activities and move on, allowing the price of the stock to sink in value in the hands of the investors who have been misled into purchasing it.

Use of Form S-8 and Form 8-K by Shell Companies, Securities Act Release No. 33-8407, Exchange Act Release No. 34-49566, 69 Fed. Reg. 21,650, 21,651 (proposed Apr. 21, 2004) (to be codified at 17 C.F.R. pts. 230, 239, 240, and 249) (footnotes and bullet points omitted); *see also* Use of Form S-8, Form 8-K, and Form 20-F by Shell Companies, Securities Act Release No. 33-8587, Exchange Act Release No. 34-52038 (July 21, 2005), 70 Fed. Reg. 42,234 (July 21, 2005) (to be codified at 17 C.F.R. pts. 230, 239, 240, and 249).

Of course, a "pump and dump" scheme need not involve a shell company; many issuers with legitimate operations could use such a scheme, particularly if the issuer has a limited trading market and is not well known, as is typical of many non-reporting Pink Sheets issuers. *See generally* Securities and Exchange Commission, Pump&Dump.con: Tips for Avoiding Stock Scams on the Internet (Jan. 11, 2005), http://www.sec.gov/investor/pubs/pump.htm. Because issuers often rely on rumors about information that is not yet public, subjecting issuers to disclosure requirements will not prevent "pump and dump" schemes. However, subjecting issuers to periodic disclosure requirements could hamper the prevalence of these schemes.

> issuing companies to meet the BBX listing standards. Once in the Pink Sheets, the issuing companies may no longer be required to be reporting companies under the 1934 Act. The more this group of companies . . . decides to drop out of the 1934 Act reporting system, the greater is the likelihood and potential for micro-cap fraud in their securities.[232]

Similarly, in a 1998 proposal to amend Exchange Act Rule 15c2-11, the Commission observed: "Without information, it is difficult for investors . . . to evaluate the risks presented by microcap securities. Investors consequently can fall prey to persons who make false representations and unrealistic predictions about these securities."[233] These concerns become even more important as the Pink Sheets continues to grow, as it has in recent years.

Perhaps the most compelling reason to make disclosures mandatory is that it may benefit the issuer, and thereby the shareholders.[234] Studies of the costs and benefits of mandatory disclosure requirements have been largely inconclusive, with some (hotly disputed) studies concluding that the securities laws have not resulted in any significant value to investors.[235] However, the implementation of the NASD eligibility rule presented an opportunity to study the effects on a substantial number of issuers becoming subject to Exchange Act reporting requirements *en masse* (or choosing to move to the Pink Sheets instead).

A recently completed study found that more than seventy-six percent of the non-Exchange Act reporters that had been traded on the OTCBB before the eligibility rule chose *not* to become Exchange Act reporters and thus were removed from the OTCBB.[236] This suggests that many firms find that the costs of Exchange Act disclosure outweigh the benefits. The study also found that these issuers (noncompliant firms) tended to be smaller than issuers that chose to become reporting companies (newly compliant firms) suggesting that a "consequence of mandatory SEC disclosures is to push smaller firms with lower

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232. FINAL REPORT OF THE 21ST ANNUAL SEC GOVERNMENT-BUSINESS FORUM ON SMALL BUSINESS CAPITAL FORMATION (Feb. 2003), http://www.sec.gov/info/smallbus/gbfor21.htm [hereinafter FINAL REPORT]. This report also noted that replacing the OTCBB with the BBX would result in many "companies simply opting to continue trading in the Pink Sheets and to forgo any incentive to become reporting companies under the 1934 Act" and that "[h]istorically, companies have lost significant market value when forced to withdraw from the OTCBB and subsequently trade in the Pink Sheets." *Id.*

233. 1998 Release, *supra* note 154, at 9662.

234. *See* ENGEL ET AL., *supra* note 7, at 5 ("A large theoretical literature in accounting argues that firms can benefit by committing [in advance] to certain types of disclosure . . . .").

235. *See* Bushee & Leuz, *supra* note 145, at 237-38 ("Early studies . . . conclude that the 1933 and 1934 Acts were of no apparent value to investors, but these findings have been repeatedly challenged . . . .").

236. *Id.* at 235 ("We document that over 2,600 (or 76%) of the firms not previously filing with the SEC did *not* comply with the required disclosures and hence were removed from the OTCBB. Thus, for the vast majority of OTCBB firms, the costs of mandatory SEC disclosures appear to outweigh the benefits.").

outside financing needs into a less regulated market, rather than to compel them to disclosure."[237] However, the authors also found that the eligibility rule resulted in "positive abnormal returns" (measured around key dates as the eligibility rule was announced and phased in) for OTCBB firms that were already SEC reporting issuers (already compliant firms), which may be the result of external factors such as the reputation of the OTCBB as a whole being improved by the eligibility rule.[238] The study found significantly lower returns for newly compliant firms than for already compliant firms;[239] however, newly compliant firms experienced increases in liquidity that were "significantly larger than for the other groups."[240] Not surprisingly, noncompliant firms experienced "significantly negative abnormal returns" when they were removed from the OTCBB.[241]

These results suggest that mandatory disclosure is a mixed bag for issuers—although it obviously entails costs, it can also result in significant benefits in terms of stock price and liquidity.[242] Clearly, many issuers that are not Exchange Act reporters would find that full Exchange Act reporting is too high a burden, regardless of possible benefits. On the other hand, requiring mandatory disclosures seems to produce positive results for issuers and investors, whether from a general belief that the market's reputation has improved or otherwise. The trick, then, is to arrive at a disclosure regime that will produce these positive results without scaring too many issuers away. In other words, the goal is to increase benefits more than costs.

### *B. General Considerations*

In determining what disclosures should be required of Pink Sheets issuers, several considerations should be kept in mind. First, any Pink Sheets issuer that is already an Exchange Act reporter should not be required to do anything

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237. *Id.* at 261.

238. *Id.* at 235 ("We find positive abnormal returns for Already Compliant firms around key announcements and phase-in dates, suggesting positive externalities from the imposition of mandatory disclosures on other firms.").

239. *Id.*

240. *Id.* at 236.

241. *Id.* at 235. Noncompliant issuers also experienced "significant and sustained decreases in all liquidity measures" after they were removed from the OTCBB. *Id.* at 236.

242. *See also* MACEY ET AL., *supra* note 198, at 5-6 (finding that delisting an issuer's securities from a stock exchange due to its failure to maintain listing requirements is detrimental to both the issuer and its security holders, even when the issuer's securities subsequently trade on the Pink Sheets, and arguing that "investors in delisted firms be provided with a 'soft-landing' in the form of an efficient alternative trading venue when these firms fail traditional listing requirements"). *See generally* Steven Huddart et al., *Disclosure Requirements and Stock Exchange Listing Choice in an International Context*, 26 J. ACCT. & ECON. 237, 260 (1999) (finding that "trading concentrates on high disclosure exchanges prompting exchanges to engage in a 'race to the top' in setting their disclosure requirements to maximize trading volume").

more.[243] Second, and most importantly, the amount of information about issuers should be sufficient to provide investors with a good basis for making investment decisions, without becoming an excessive burden on the issuer. If the burden is too high, it is likely that issuers will not comply, as demonstrated by the aftermath of the eligibility rule discussed above. As such, full Exchange Act reporting status is too high a burden, as evidenced by the many issuers that fled the Exchange Act after SOX.

Another concern involves the fact that whether an issuer's stock is quoted on the Pink Sheets is beyond its control. Thus, imposing disclosure requirements on all Pink Sheets issuers could in some cases be unfair, particularly because it would result in disclosure of sensitive financial and business information that issuers would prefer to keep out of the hands of their competitors. For example, consider the situation where Company A, a competitor of Company B, manages to acquire some Company B stock and then attempts to have it quoted on the Pink Sheets so that Company B would be required to divulge information to the public. Instead, any disclosure requirements that are imposed on Pink Sheets issuers should only apply if the issuer—or any affiliate of the issuer—has taken some steps to facilitate a market for the issuer's securities or otherwise availed itself of the capital markets. For issuers that have not done so, perhaps the current approach of Rule 15c2-11 is sufficient.

Another basic consideration is that if less informational and other requirements are imposed on Pink Sheets issuers than Exchange Act reporters, steps should be taken to make investors aware of this fact because some may think that the Pink Sheets is simply another securities market like NYSE or NASDAQ.[244] Warnings delivered in a manner similar to penny stock disclosures may be helpful in this regard, as discussed below.[245] In this vein, if an issuer refuses to comply with any disclosure requirements, as may occur where its securities are traded on the Pink Sheets without its involvement or blessing, or perhaps even over its objections, investor warnings are all that could likely be accomplished, short of refusing to allow that company to be traded at all. On the

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243. Similarly, foreign issuers that are subject to disclosure requirements under the laws of their home country and domestic issuers that are banking or insurance reporters exempt from registration under Section 12(g) of the Exchange Act should not be required to do anything further, assuming that the information disclosed is reasonably available to the public.

244. As Professor Leuz observed, markets may want to consider establishing different "tiers" of disclosure levels, with the lower tiers featuring prominent "buyer beware" warnings. Knowledge Wharton, Do High Regulatory Costs Force Public Firms to Go Private?, Sept. 10, 2003, http://knowledge.wharton.upenn.edu/index.cfm?fa=viewarticle&id=847 (website requires free registration). "This might strike a balance between the SEC's job of protecting investors and the desire not to overburden companies with regulations." *Id.* Apparently the Pink Sheets is contemplating a similar approach. *See* Dugan, *supra* note 123 (discussing the Pink Sheets' plans to create three different tiers of issuers, but noting that "it remains to be seen whether other issuers [will] jump to join" because "many are on the Pink Sheets because they don't want to disclose information").

245. *See infra* note 379 and accompanying text.

other hand, if an issuer is trading on the Pink Sheets as a result of its own (or its insiders') efforts, then it would seem reasonable to require the issuer to provide the information. Finally, in the past the Commission has suggested that Rule 15c2-11 information be available in an information "repository" to make it more accessible to investors and alleviate the burden on broker-dealers to provide the information to customers and others.[246] Some suggestions toward this goal are discussed below.[247]

### *C. Information That Should be Required*

The Exchange Act requires public issuers to disclose an enormous amount of information to the public. The history of the Exchange Act can be seen as the story of an ever-increasing list of required disclosures, each added for reasons that the Commission found compelling (even if some others would disagree). Indeed, a strong case can be made why each required item of information is important to investors. Nonetheless, this Article does not advocate imposing full Exchange Act reporting status on Pink Sheets issuers. Doing so would create too great a burden for these companies, many of which have taken steps to avoid the Exchange Act altogether.

Instead, a compromise should be reached to address the active and growing trading market for the securities of thousands of issuers for which little information is available. In this sense, requiring some additional information, and making it easier for investors to access this information, would be a step in the right direction. For these reasons, this Article advocates that the following information should be disclosed, as it is fundamental to an investment decision, yet does not go too far toward making Pink Sheets companies "minor league" Exchange Act reporters. A case can be made that additional information should be required; however, the following is intended to highlight major areas for consideration.

*1. Financial Statements and MD&A.*—Recent financial statements prepared in accordance with GAAP are probably the most important information for an investment decision. An investor obviously wants to know whether a company is profitable or not. However, Exchange Act Rule 15c2-11 permits financial statements that could be quite stale and that may not conform to GAAP.[248] As such, annual and quarterly GAAP financial statements should be required within reasonable deadlines so that investors know the issuer's current results. Although audited financial statements are preferable, reviewed financial statements would also be acceptable, particularly if the issuer or the trading activity in its stock is sufficiently small. In addition, some management discussion of the financial statements and future trends and contingencies is warranted, but it need not be as detailed as the required MD&A portions of

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246. *See infra* notes 340-45 and accompanying text.

247. *See infra* notes 359-73 and accompanying text.

248. 17 C.F.R. § 240.15c2-11 (2005); *see supra* notes 170-71 and accompanying text.

periodic Exchange Act reports.[249] In addition to knowing whether the company is making money or losing money, an investor also should be entitled to an explanation why.

*2. Business Information.*—Information about the issuer's business activities; products or services; properties; and threatened, pending, and recently completed litigation is also vitally important. Unlike financial statements, however, it would not be helpful to require this information more than once annually, unless there is a material change. The disclosures required by the Small Corporate Office Registration ("SCOR") form, Form 1-A under Regulation A, or those required by the first part of the Pink Sheets Disclosure Policy (all of which are discussed below) would be appropriate mechanisms for disclosure of these topics, supplemented by current disclosures of significant interim events, along the lines of what Form 8-K requires.

*3. Management Information.*—Although information about an issuer's business and financial condition is important to an investor, information about its management and promoters is also vital; an investor should know who is running the issuer. To this end, information concerning the backgrounds (including any adverse information such as criminal convictions or regulatory proceedings) and experience, stock and option ownership levels, and compensation of the issuer's management and promoters should be available, along with information about transactions and other relationships between the issuer and its insiders.

*4. Material Current Events.*—Finally, an issuer should not wait until the due date of its next periodic report to disclose important events that could have a material, immediate impact on the issuer and the valuation of its securities. As such, current information about significant non-recurring events, such as some of the events that trigger the obligation to file a Form 8-K, should be required to some degree.

Again, all of this information could be much less extensive than what the Exchange Act requires, particularly with regard to management compensation issues, yet still provide an enormous benefit to investors. It is possible to arrive at a solution that balances the interests of investors with the interests of issuers.

### *C. Possible Disclosure Models*[250]

*1. The Pink Sheets Disclosure Policy.*—The first candidate for a disclosure model is the Pink Sheets' Disclosure Policy itself. However, the Disclosure Policy has many defects. First, it only applies to issuers that have *not* previously had securities traded on an exchange, NASDAQ, or the OTCBB. This would

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249. *See supra* note 42 and accompanying text.

250. Another approach to be considered is found in Regulation D under the Securities Act, 17 C.F.R. §§ 230.501-.508 (2005), which requires that certain information be provided to persons who are not "accredited investors" in a Rule 505 or a Rule 506 offering. *Id.* § 230.502(b)(2)(i). These requirements are similar to Regulation A. 17 C.F.R. § 239.90 (2005). As such, Regulation D disclosures are not discussed further in this Article.

mean that quotations for the securities of a listed issuer that decided to "go dark" would never be subject to the Disclosure Policy and would instead only be subject to Rule 15c2-11 or nothing at all if they qualified for the "piggyback" exception or the unsolicited-quotation exception.[251]

Second, the Disclosure Policy only applies to securities that are quoted on an unsolicited basis.[252] This seems puzzling at first because Rule 15c2-11 itself does not impose any informational requirements when the quote is unsolicited, seeming to reflect the idea that there is less risk of fraud and manipulation when an investor, not a broker, is the source of the interest in the security (although this does not protect the counter-party to the investor). On the other hand, an exception for unsolicited quotes could be abused and the issuers of securities that are quoted exclusively on an unsolicited basis may never have made *any* information public.[253] Nonetheless, it is strange to require *more* information for unsolicited quotes. In any event, if the goal of reform is to create a more transparent market in Pink Sheets securities, it matters little whether a quote is solicited or unsolicited; an investor should be entitled to some information in all cases. Third, the Disclosure Policy applies only in certain situations, such as when the security is first quoted in the public markets or when the issuer's insiders are offering, buying, or selling its securities.[254] The Disclosure Policy is thus not *always* applicable, unlike Exchange Act reporting obligations.

Turning from coverage issues to substantive issues, the first part of the Disclosure Policy elaborates on the requirements of Rule 15c2-11[255] and the second part functions much like Form 8-K.[256] Generally speaking, the Disclosure Policy does well specifying the information required with respect to the issuer's business, properties, and pending litigation, and in many instances looks much like a reworked version of portions of Regulation S-K. It also requires a great deal of information concerning the employment histories of executive officers, directors, and other insiders, as well as information about their stock ownership levels,[257] and whether they have been involved in specified criminal or

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251. *See supra* notes 174-78 and accompanying text.

252. *See supra* note 174 and accompanying text.

253. As the Commission noted: "The unsolicited status of the underlying customer orders would be called into question if a broker-dealer repeatedly publishes quotations on the basis of [the unsolicited order] exception." 1998 Release, *supra* note 154, at 9669. The Pink Sheets website also observes: "Pink Sheets has become increasingly concerned that the unsolicited quote exception in Exchange Act Rule 15c2-11 is being abused by unscrupulous individuals to engage in questionable and possibly fraudulent activities . . . ." Pink Sheets, Quoting Pink Sheets Securities: Unsolicited Quotes, http://www.pinksheets.com/otcguide/brokers_index.jsp (last visited Jan. 16, 2005).

254. *See supra* note 177 and accompanying text.

255. *See supra* notes 184-97 and accompanying text.

256. *See supra* note 183 and accompanying text.

257. It is unclear whether any disclosure of options information would be required. However, page three of the Disclosure Policy does require information about options that have been granted within the past two years. Disclosure Policy, *supra* note 173, at 3.

disciplinary proceedings similar to those specified in Item 401(f) of Regulation S-K[258] and Rule 262 of Regulation A.[259]

The Disclosure Policy also requires sufficient information with respect to financial statements. First, it requires that they be prepared in accordance with GAAP. Second, in addition to annual financial statements, it requires quarterly financial information, e.g., a balance sheet as of the end of the most recent quarter, as well as income, cash flows, and shareholders' equity statements for that quarter and the corresponding period in the prior year.[260] Annual financial information will not be considered "current" more than ninety days after the end of the following fiscal year and quarterly financial information will not be considered current more than forty-five days after the end of the following quarter.[261] Third, the Disclosure Policy requires that the financial statements either be audited or the CFO or another person responsible for preparing the statements must certify that the statements present the issuer's financial position and results fairly, in all material respects.[262] This is a reasonable alternative to requiring audited financial statements, which involve much more expense and loss of management time than do reviewed financial statements.

The first part of the Disclosure Policy runs into problems, however, because it does not require anything resembling an MD&A section or any management compensation information (other than information about stock and options that were "issued for services" within the past two years).[263] It is also vague in several instances. For example, it requires the issuer to "[d]escribe any relationships existing among and between the issuer's officers, directors and shareholders," without explaining what types of "relationships" are covered.[264] Perhaps a better way to approach this requirement would be to borrow from Item 404 of Regulation S-K, which requires disclosures about a well-defined universe of related-party transactions and other relationships between the issuer and certain insiders.[265] The Disclosure Policy also seems to require too much information in some places; for example, one wonders whether the ten-year employment history of the issuer's public relations consultants would really be useful information to many investors.[266]

The second part of the Disclosure Policy seems largely to be a "cut and paste job" that fails to take into account important differences between Exchange Act

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258. 17 C.F.R. § 229.401 (2005).

259. 17 C.F.R. § 230.262 (2005).

260. Disclosure Policy, *supra* note 173, at 9.

261. *Id.* at 10.

262. *Id.* In addition, the Disclosure Policy provides that issuers "should," with respect to the entire contents of the policy, include a certification by appropriate officer(s) that "they have prepared or reviewed such information and the notes thereto, and the information is complete and presented fairly, in all material respects." *Id.* at 2.

263. *Id.* at 2-3.

264. *Id.* at 9.

265. 17 C.F.R. § 229.404 (2005).

266. *See* Disclosure Policy, *supra* note 173, at 7-8.

reporters and other issuers. For example, Item 15 of the second part of the Disclosure Policy requires information whenever the issuer's code of ethics that applies to its principal executive and financial officers and similar officers has been amended.[267] However, a non-Exchange Act company that is not listed on an exchange or quoted on NASDAQ is not even required to have such a code of ethics in the first place. Similarly, Item 10 of the Disclosure Policy requires certain information when the issuer's principal independent accountant resigns or similar events occur.[268] As with the code of ethics, however, a non-reporting Pink Sheets issuer is not required to have audited financial statements, or even an outside accounting firm (although it may voluntarily).[269]

This is not to say that the second part of the Disclosure Policy does not require disclosure of important information. However, it does seem overbroad in terms of what information it requires; it clearly would benefit from careful tailoring to take into account the peculiarities of non-reporting issuers.[270] Perhaps a better approach would be to require the disclosures that Form 8-K required *before* SOX, which largely concerned changes in control, acquisitions, or dispositions of significant amounts of assets; bankruptcy and similar proceedings; changes in accountants (assuming the company has outside accountants); and resignations of directors.[271] Such events are tremendously important to investors. The same cannot be said of all of the disclosures required by the current version of Form 8-K, at least insofar as smaller issuers are concerned. This approach would also have the benefit from the issuer's perspective of keeping required disclosures to a more manageable level.

2. *Regulation A Disclosures.*—Disclosure for non-reporting Pink Sheets issuers could alternatively be modeled on Regulation A requirements. Regulation A[272] establishes an exemption from registration under the Securities Act for certain public offerings of securities by eligible non-public issuers.[273] Regulation A specifies many conditions the issuer must meet, including filing a Form 1-A offering statement with the Commission, the "qualification" of which is required before sales may be made.[274] In this way, Regulation A establishes a "mini-registration" process—the information it requires is much less onerous

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267. *Id.* at 20-21.

268. *Id.* at 16-17.

269. *See id.* at 10. Similarly, Items 4 and 5 of the second part of the Disclosure Policy concern certain off-balance sheet arrangements, disclosure of which was required for public companies by Section 401 of SOX but perhaps are less likely to apply to many small companies. *Id.* at 13-15.

270. Another problem is that the Pink Sheets Disclosure Policy omits important guidance. For example, Item 3 of the second part requires information when the issuer has completed the acquisition or disposition of a "significant" amount of assets, without defining that term, unlike the specific guidance given in Item 2.01 of Form 8-K. *See id.* at 13.

271. *See* 17 C.F.R. § 249.308 (2003).

272. 17 C.F.R. §§ 230.251-.263 (2005).

273. *Id.* § 230.251(a). The usual dollar limit on a Regulation A offering is $5 million. *Id.* § 230.251(b).

274. *Id.* § 230.251(d)(2).

from the issuer's perspective than a Securities Act registration form.

Form 1-A allows an issuer to choose between disclosure alternatives, including Model A and Model B.[275] With respect to non-financial information, Model A requires the issuer to answer a series of questions about various aspects of its business and the proposed offering.[276] Model B requires similar information but allows the issuer to present it in a more "traditional" prospectus format.[277] Form 1-A seems well designed to require much of the information that is crucial to an investment decision, as identified above.[278] Specifically, a sufficient—but not onerous—amount of information is required about the issuer's business activities, properties, pending litigation, management and promoter backgrounds, stock and stock option ownership levels, compensation, and related-party transactions.[279]

Form 1-A also requires GAAP financial statements.[280] For most issuers this will be a balance sheet ninety or fewer days old,[281] and statements of income, cash flows, and stockholders equity for each of the two fiscal years before the recent balance sheet, as well as any interim period between the most recent fiscal year end and the most recent balance sheet date.[282] The financial statements need not be audited, but if the issuer has audited financial statements it must provide them.[283] Model A of Form 1-A also requires a brief "Management's Discussion

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275. *See* Form 1-A, 17 C.F.R. § 239.90 (2005), *available at* http://www.sec. gov/about/forms/form1-a.pdf.

276. *Id.* at 4-21.

277. *Id.* at 22-30.

278. In addition, much like Securities Act Rule 408, 17 C.F.R. § 230.408, with respect to registered offerings, Rule 252(a) provides that Regulation A offering statements must include "any other material information necessary to make the required statements, in the light of the circumstances under which they are made, not misleading." *Id.* § 230.252(a).

279. Form 1-A, *supra* note 275.

280. *Id.* at 30.

281. *Id.* The Commission may permit older balance sheets (up to six months old) upon a showing of "good cause." *Id.* In addition, if the filing is made more than ninety days after the issuer's most recent fiscal year, a balance sheet as of the end of the most recent fiscal year must be included. *Id.*

282. *Id.* Part F/S further requires that:

> Income statements shall be accompanied by a statement that in the opinion of management all adjustments necessary for a fair statement of results for the interim period have been included. If all such adjustments are of a normal recurring nature, a statement to that effect shall be made. If otherwise, there shall be furnished as supplemental information . . . a letter describing in detail the nature and amount of any adjustments other than normal recurring adjustments entering into the determination of results shown.

*Id.*

283. However, if audited financial statements are filed, the qualifications and reports of an independent auditor must comply with the requirements of Article 2 of Regulation S-X, 17 C.F.R. § 210.2-01-07 (2005). Form 1-A, *supra* note 275, at 30.

and Analysis of Certain Relevant Factors," in which the issuer answers a series of questions.[284] Although not nearly as extensive as an MD&A section in an Exchange Act report, this information would nonetheless be very useful to an investor when evaluating an issuer's financial statements. For example, it requires the issuer to describe any trends in its financial results and, if the issuer has experienced losses from operations, to explain why and describe the steps that it is taking to address these problems.[285]

*3. SCOR Disclosures.*—Another potential model for disclosure for non-reporting Pink Sheets issuers is the Small Corporate Offering Registration (SCOR) form, Form U-7, the most recent version of which was approved by the North American Securities Administrators Association in 1998.[286] This form, which a substantial majority of states have adopted,[287] is typically used to register a federal Rule 504 offering under state "blue sky" laws, meaning that the offering is limited to $1 million in any twelve-month period.[288] As commentators put it: "SCOR has fashioned a balanced approach between 'full' disclosure, as defined by SEC registration forms and rules relating to disclosure, and sufficient information to protect investors under most circumstances by providing a uniform form to reduce the costs of compliance without sacrificing investor protection."[289] As with Form 1-A, the SCOR form requires a reasonable amount of information about the issuer, its business activities, its management, and similar matters.

As for financial statements, the SCOR form usually requires a balance sheet as of the end of the most recent fiscal year,[290] statements of income, cash flows and stockholders' equity for the most recent fiscal year (or such shorter period as the issuer has been in existence), and statements of income and cash flows for any interim period at least as current as the end of the issuer's most recent third fiscal

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284. Form 1-A, *supra* note 275, at 21.

285. *Id.*

286. *See* North American Securities Administrators Association, Form U-7 (Sept. 28, 1999), *available at* www.iid.state.ia.us/docs/scor_form.pdf [hereinafter SCOR Form].

287. *See generally* Hugh H. Makens & Willie R. Barnes, *Blue Sky Developments Part II: Small Corporate Offering Registration—Form U-7*, REGULATION D OFFERINGS AND PRIVATE PLACEMENTS (2004), *available at* SK066 ALI-ABA 371 (Westlaw). This Article was included in a book of materials for seminars sponsored by the American Law Institute and the American Bar Association in 2004, beginning on page 233; the electronic version has different pagination.

288. 17 C.F.R. § 230.504 (2005). It has also been accepted by the Commission for Regulation A offerings and offerings of up to $5 million registered on Securities Act Form SB-1. Makens & Barnes, *supra* note 287, at 237, *375.

289. Makens & Barnes, *supra* note 287, at 237, *375.

290. North American Securities Administrators Association, NASAA Small Company Offering Registration (SCOR) Manual 95 (Sept. 28, 1999), *available at* http://www.iid.state.ia.us/docs/scor_man.pdf. If the effective date of the registration is within forty-five days after the issuer's fiscal year end, then the balance sheet may be as of the end of the prior fiscal year; however, in that case the issuer must also include a balance sheet at least as current as the end of its most recent third fiscal quarter.

quarter.[291] Financial statements must be prepared in accordance with GAAP.[292] Interim financial statements may be unaudited.[293] Annual financial statements must be audited; however, if certain conditions are met, they may instead be reviewed.[294]

The SCOR form, much like Model A of Form 1-A, features a fill-in-the-blank and question-and-answer format.[295] Instead of a full MD&A section, the issuer answers a series of questions concerning its financial health.[296] Although the form seems designed for relatively new and small companies, its format is likely more beneficial to prospective investors than a traditional prospectus because "just by including the question, [it] provides information to the reader, regardless of whether the corresponding answer is affirmative or negative."[297]

*4. Which Disclosure Model is the Best?*—Each of the Pink Sheets Disclosure Policy, Form 1-A, and SCOR generally requires reasonable amounts of information, subject to some deficiencies. However, because each of these possible disclosure models has advantages and disadvantages, one designing a disclosure regime for non-reporting Pink Sheets issuers would do well to borrow ideas from all of these forms.[298] For example, the question-and-answer format of Model A of Form 1-A and the SCOR form is attractive because it would alert investors to the *absence* of certain information, and issuers would likely find it easier to complete a standardized form.[299]

As for financial statements, the Pink Sheets Disclosure Policy seems the best approach, largely because it contemplates ongoing financial disclosures, unlike Form 1-A and the SCOR form.[300] First, it requires that the financial statements be prepared in accordance with GAAP and that annual financial statements either be audited or include a management certification.[301] Second, it requires all of the usual financial statements (balance sheet, income statement, cash flows statement and shareholders' equity statement) and specifies reasonable deadlines for them (ninety days after the

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291. *Id.* at 95-96.

292. *Id.* at 96.

293. *Id.*

294. *Id.* These conditions include (1) the amount of the offering does not exceed $1 million, (2) the aggregate amount of all previous sales of securities by the issuer (with exclusions for certain debt securities) did not exceed $1 million, and (3) the issuer has not been previously required under federal or state securities laws to provide audited financial statements in connection with a sale of its securities. *Id.*

295. SCOR Form, *supra* note 286, at 1-36.

296. *Id.* at 17-19.

297. Makens & Barnes, *supra* note 287, at 237, *375.

298. Many portions of Form 1-A and the SCOR form that concern offering-specific information such as use of proceeds would obviously not be well-suited for a periodic disclosure document unrelated to a specific securities offering.

299. To be fair, the Pink Sheets Disclosure Policy also requires issuers to "provide a response to each Item and sub-item . . . and include in their response whether a particular Item is not applicable or the information is unavailable and the reason it is not applicable or unavailable." Disclosure Policy, *supra* note 173, at 2.

300. *Id.* at 9-10.

301. *Id.*

end of the year or forty-five days after the end of the quarter).[302] Two slight modifications borrowed from Form 1-A may be warranted, however. First, if an issuer has audited financial statements, it should be required to provide them. Second, interim financial statements should be accompanied by a statement of management regarding any necessary adjustments.[303]

The Pink Sheets Disclosure Policy, however, does not require any MD&A-style discussion. Comparing Form 1-A to the SCOR form, SCOR's requirements in this area seem preferable because they are slightly broader than Form 1-A.[304] Although these requirements are much less detailed than Item 303 of Regulation S-K, both Form 1-A and the SCOR Form nonetheless ask important questions about trends in the issuer's historical operating results and, if applicable, steps the issuer is taking to address losses from operations.

Finally, the Pink Sheets Disclosure Policy is the only one of these three approaches that requires information about non-recurring events that affect the issuer, such as in a Form 8-K.[305] This is obviously because the other two forms are directed at specific points in time (i.e., the time of a securities offering) rather than ongoing disclosure obligations. As discussed above, however, one would do well to model such disclosures after the pre-SOX Form 8-K rather than the second part of the Pink Sheets Disclosure Policy.

The above comparison of the strengths and weaknesses of the different approaches, although helpful in the abstract, obviously is not intended as a definitive guide to create a disclosure form for Pink Sheets issuers. Indeed, any attempt to do so would result in a level of detail far beyond what is useful in an article such as this. Instead, it identifies some major themes and concerns to facilitate the task of future regulators. Again, the overall goal is to ensure that a sufficient amount of important information is available to investors without overburdening issuers.

### *E. Possible Approaches to Implementing Disclosure Requirements*[306]

In June 2005, R. Cromwell Coulson, the CEO of the Pink Sheets, wrote a letter

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302. *Id.* Given that many Pink Sheets issuers are likely to be less well-staffed than larger companies, perhaps longer deadlines would be in order.

303. *See supra* note 282.

304. *Compare* SCOR Form, *supra* note 286, at 17-19, *with* Form 1-A, *supra* note 275, at 21.

305. Disclosure Policy, *supra* note 173, at 12-21.

306. Another possible approach would be to amend state laws to require greater informational requirements for issuers incorporated or organized in the state. However, the fact that there are fifty states would mean that the laws of each state would need to be amended to achieve uniformity. Political realities being what they are, it is unlikely that a uniform approach could be adopted in a significant number of states. Any state that did not adopt such laws, or that adopted less demanding laws, may receive an influx of corporations reincorporating there, given that a corporation may incorporate in any state even if it has no operations there. States eager to supplement governmental revenues through the collection of corporation franchise fees would likely engage in a "race to the bottom" to encourage corporations to reincorporate there to take advantage of favorable disclosure laws, or lack thereof.

to the Commission's Advisory Committee on Smaller Public Companies[307] in which he stated that the "current regulation of non-reporting issuers is woefully deficient and fails to protect investors" and urged the committee to consider steps to remedy this problem.[308] Mr. Coulson argued that non-Exchange Act companies should have reporting obligations (1) when insiders are trading securities in the public markets and (2) when "the issuer is conducting promotional activities intended to encourage public trading in its securities."[309] He also argued that the Commission should establish a website where this information could be easily available.[310] Mr. Coulson further wrote that the Commission should abandon its efforts to achieve similar goals by amending Rule 15c2-11 (which in its current form places the information-gathering burden on broker-dealers) and instead place "the responsibility and burden of continuing disclosure where it belongs—on issuers."[311]

Although there is much to admire about Mr. Coulson's proposals,[312] one should note that they would result in a non-reporting Pink Sheets issuer having disclosure obligations only sporadically, i.e., when its insiders are trading the issuer's shares or the issuer is engaged in "promotional activities" to encourage trading by others. With respect to the first of these circumstances, Mr. Coulson argues that it is based on a "fundamental principle of market fairness: The uninformed may trade with the uninformed, those who are informed may trade with each other, but the informed may not trade with the uninformed."[313] Obviously, allowing trading by well-informed insiders in the absence of publicly available information about the issuer would violate the last aspect of this principle.

But should the securities laws allow the uninformed to trade Pink Sheets securities with the uninformed? As an initial matter, this is not the approach that the Exchange Act takes with respect to reporting companies. The Exchange Act requires an enormous amount of information to be made public—and it requires this information on an ongoing basis regardless of whether the issuer's insiders are trading its securities or the issuer is encouraging others to do so. In other words, the Exchange Act gives every investor the tools always to be "informed." Second, Mr. Coulson argues that buyers and sellers who have equal access to information (or perhaps *no* information), will set a fair price although "[i]t may not be the correct

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307. *See infra* note 357.

308. Coulson 2005 Letter, *supra* note 166, at 1.

309. *Id.* at 6-7.

310. *Id.* at 2. As to this point, Mr. Coulson bemoaned the fact that although Rule 144 under the Securities Act, 17 C.F.R. § 230.144 (2005), requires that there be publicly available information about an issuer before an insider or a holder of restricted securities may sell the issuer's securities pursuant to the rule, the Commission has not clarified how this requirement can be met in the case of a non-Exchange Act issuer. *Id.* at 8 n.11.

311. Coulson 2005 Letter, *supra* note 166, at 6.

312. Another excellent proposal that Mr. Coulson made is that NASD Rule 2460, which prohibits broker-dealers from receiving fees for assisting issuers in gathering the required Rule 15c2-11 information, should be rescinded. *See id.* at 5. As a result of this rule, unregulated entities such as public relations firms, step in to fill this void—and receive fees for doing so. *See id.*

313. *Id.* at 7 (emphasis omitted).

price."[314] Although this may be true from a philosophical standpoint, it begs the question—why not require continuous information so that investors are able to set the "correct" price or some approximation of it?

Mr. Coulson argued that at times other than the two situations described above, "the benefits of . . . disclosure do not justify its costs" because "the cost of being a reporting issuer is now prohibitive" after SOX.[315] In other words, Mr. Coulson may believe that the only alternatives available to the Commission are (1) continuing with the status quo, which is not desirable or (2) the prohibitively costly alternative of requiring non-reporting Pink Sheets issuers to become full-blown Exchange Act registrants.[316] However, it is possible for the Commission to revise its rules to require non-reporting Pink Sheets issuers to make periodic disclosures if they have purposely availed themselves of the public markets and—most importantly—tailor the disclosure obligations of such issuers so that they are far less onerous than what is required by the Exchange Act.[317] This Article now turns to considering the means to do so.

*1. Pink Sheets Disclosure Policy.*—The first and most obvious approach to making more information about Pink Sheets issuers that are not Exchange Act reporters available to the public is the Pink Sheets Disclosure Policy. Assuming that its coverage were broadened to include all Pink Sheets issuers that are not Exchange Act reporters and to apply at all times, a few additional problems come to mind. First, as an unregulated entity, nothing requires the Pink Sheets to receive Commission approval of any rule changes or to submit proposed rule changes to a public comment process, as is required for Commission and SRO rules. For example, if the Pink Sheets finds that the Disclosure Policy is sufficiently objectionable to the users of its services (i.e., broker-dealers who will likely not want to comply with the detailed requirements of the Disclosure Policy when entering unsolicited quotes), it could terminate it. Second is the issue of whether the Pink Sheets is sufficiently staffed to ensure compliance with its rules. Further, the Pink Sheets has no authority to impose fines on those who do not follow its rules—its only recourse for a violation would be to discontinue the quotation of an issuer's securities or to prevent a broker-dealer from using the Pink Sheets' services. Finally, although perhaps unlikely, nothing would prevent a competitor of the Pink Sheets—one that did not share its commitment to investor protection and periodic disclosures by issuers—from setting up shop and enticing brokers and issuers to use its services.

*2. Amending Rule 15c2-11.*—One way to increase the level of information that is required of Pink Sheets companies would be to amend Rule 15c2-11. As discussed above, this rule specifies the information that a broker-dealer must have in its records before it publishes any quotation for a security in a quotation medium such as the Pink Sheets.[318] Desirable changes to Rule 15c2-11 would include increasing the amount of information required about issuers, making it easily available to investors,

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314. *Id.*

315. *Id.* at 13.

316. *See id.*

317. *See infra* notes 357-58 and accompanying text.

318. *See supra* notes 151-72 and accompanying text.

eliminating the "piggyback" exception, and shifting the burden of gathering the information from broker-dealers to issuers. In fact, in 1998 and 1999, the Commission proposed similar changes to Rule 15c2-11.[319] But more than six years have now passed without any amendments to Rule 15c2-11 resulting from these proposals.[320]

The Commission made the 1998 proposal "in response to increasing incidents of fraud and manipulation in the over-the-counter securities market involving thinly traded securities of thinly-capitalized issuers."[321] The 1998 proposal concerned several changes to Rule 15c2-11, including eliminating the "piggyback" provision,[322] expanding the information required about non-Exchange Act issuers,[323] increasing investor access to the information required by the rule, and requiring broker-dealers

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319. *See* 1998 Release, *supra* note 154; 1999 Release, *supra* note 165.

320. The comment period with respect to the 1999 proposal expired on May 8, 1999. *See* Extension of Comment Period: Reproposed Rule: Publication or Submission of Quotations Without Specified Information, Exchange Act Release No. 34-41261, 64 Fed. Reg. 18,393 (April 14, 1999). *But see* FINAL REPORT, *supra* note 232 (suggesting certain changes to Rule 15c2-11).

321. 1998 Release, *supra* note 154, at 9661.

322. Subsection (f)(3) of the rule, colloquially known as the "piggyback" provision, basically provides that the informational requirements of the rule do not apply when the security has already been the subject of quotations, even by other brokers, over specified periods of time, usually thirty days, before the current quotation. 17 C.F.R. § 240.15c2-11(f)(3) (2005). As the Commission explains, this provision "is grounded on the assumption that regular and frequent quotations for a security generally reflect market supply and demand forces based on independent, informed pricing decisions." 1998 Release, *supra* note 154, at 9663. In 1991, the Commission attempted to remove the piggyback provision, but was met with resistance from the brokerage community, which argued that eliminating the provision would discourage market-making for non-NASDAQ OTC securities. *See id.* (discussing Initiation or Resumption of Quotations Without Specified Information, Securities Exchange Act Release No. 34-29094, 56 Fed. Reg. 19,148 (April 25, 1991), and Initiation or Resumption of Quotations Without Specified Information, Securities Exchange Act Release No. 34-29095, 56 Fed. Reg. 19,158 (April 25, 1991), and noting that the "vast majority" of commenters opposed the proposed change, arguing that it would "discourage, or even eliminate, market making for many non-Nasdaq OTC securities"). In the 1998 release, the Commission argued that eliminating the piggyback provision was an "essential step to preventing microcap fraud.... [R]esponsible broker-dealers would be deterred from publishing quotations if they were aware of basic information about the issuer that suggested a possible fraud." *Id.* at 9663-64.

323. The Commission also proposed minor changes to the information required about other types of issuers, such as clarifying that Exchange Act reporting issuers must be current in their Exchange Act reporting. 1998 Release, *supra* note 154, at 9665. Although at least one commenter had suggested that this problem could be solved by marking quotations of delinquent reporters to indicate that current information about the issuer was unavailable, the Commission did "not view this alternative as responding adequately to the problem of active trading facilitated by priced quotations without current information. Moreover, that approach would remove an incentive that delinquent issuers may have to provide current information to their shareholders and the marketplace." *Id.*

that publish priced (as opposed to unpriced[324]) quotations for a security to obtain and review updated information about the issuer annually.[325]

For U.S. non-reporting issuers, the Commission proposed revising Rule 15c2-11 to require expanded information about the issuer's outstanding securities and capital structure; its control persons (e.g., criminal and other disciplinary actions within the past five years that may raise "red flags"); its financial statements (including a requirement that the financial statements comply with GAAP); and "significant events" involving the issuer within the past two years, such as mergers, acquisitions or dispositions of assets, and changes in control.[326] The Commission stated that these amendments would provide broker-dealers with a "greater understanding of the issuer's operations and a better indication of whether potential or actual fraud or manipulation may be present."[327]

Although Rule 15c2-11(a)(5) requires that paragraph (a) information be made available by the broker-dealer to any person expressing an interest in a transaction in that security with the broker-dealer,[328] the piggyback provision essentially means that only the first broker-dealer to publish quotations for the security needs to have the information, making it difficult for most investors to obtain the information.[329] As such, the Commission proposed to impose this requirement on *every* broker-dealer that published a quotation for the security.[330] However, to ease the burden of eliminating the piggyback provision and expanding the information required of non-Exchange Act reporting companies, the Commission suggested establishing a repository of information about non-Exchange Act reporters, as discussed further below.[331] It seems that the Commission had in mind something similar to its EDGAR system,[332] but privately run.

The 1998 proposal met with resistance from the brokerage community, resulting in the Commission's release in 1999 of a scaled-back proposal which would have revised the rule to focus principally on priced quotations, but not unpriced quotations.[333] The 1999 proposal would also have completely exempted certain

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324. The Commission defined a priced quotation as a "bid or offer at a specified price" and an unpriced quotation as "any indication by a broker or dealer in receiving bids or offers from others or any indication by a broker or dealer that advertises its general interest in buying or selling a particular security." *Id.* at 9664 n.29.

325. The Commission defended this proposal by noting that a broker-dealer "should know if there is no current information about the issuer or if the current information reflects a significant change in the issuer's ownership, operations, or financial condition." *Id.* at 9664.

326. *Id.* at 9667.

327. *Id.* at 9671.

328. 17 C.F.R. § 240.15c2-11(a)(5) (2005).

329. *See id.* § 240.15c2-11(f)(3).

330. 1998 Release, *supra* note 154, at 9663.

331. *Id.* at 9670.

332. *See* 17 C.F.R. §§ 232.10-.501 (2005).

333. 1999 Release, *supra* note 165. The Commission noted that the 1998 proposal had generated 199 comment letters, the majority of which opposed many of the proposed changes. According to the Commission:

securities from Rule 15c2-11, including (1) securities of issuers with net tangible assets above $10 million, (2) securities with a bid price of at least $50 per share, and (3) securities with a worldwide average daily trading value of at least $100,000 during each of the past six months.[334] In the Commission's view, these securities are less "likely to be the subject of improper activities"[335] and "applying the Rule to the securities of larger issuers [and] more liquid securities . . . is not directly related to microcap fraud concerns."[336]

It is obvious from the release that the Commission's focus was not improving the information available to investors but attempting to reduce microcap fraud; the Commission began the release by saying it "has made combating microcap fraud one of its top priorities"[337] and seemed especially concerned that priced quotations lend an air of legitimacy to securities that could be the subject of a "pump and dump" scheme.[338] In fact, the Commission noted that the overall purpose of Rule 15c2-11 was to "prevent broker-dealers from becoming involved in the fraudulent manipulation of OTC securities."[339]

Another aspect of these proposals is noteworthy. As noted above, Rule 15c2-11 currently requires a broker-dealer to make information available upon request to those who express an interest in a transaction in the security with the broker-dealer.[340] Although the 1998 proposal would have required a broker-dealer to provide this information to anyone,[341] the 1999 proposal would have required the broker-dealer to provide it only to current or prospective customers, other broker-dealers, and information repositories.[342] However, if the information were on EDGAR or in such

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> Commenters also expressed views about the possibility of: reduced liquidity in covered OTC securities if broker-dealers stopped making markets; less transparent markets if broker-dealers did not publish priced quotes to avoid the annual review requirement; less competitive pricing for covered OTC securities; impaired access to capital by issuers; and increased compliance costs for broker-dealers. . . . Some commenters also remarked that the proposal would not stop microcap fraud, which, in their view, is really a sales abuse problem.

*Id.* at 11,126-27.

334. *Id.* at 11,127.

335. *Id.*

336. *Id.* at 11,128. The Commission estimated that these exceptions would apply to approximately ten percent of OTC securities. *Id.* at 11,128 n.25.

337. *Id.* at 11,125. Of course, these two goals are not inconsistent: more information means less possibility for fraud. However, excluding issuers with net tangible assets in excess of $10 million from Rule 15c2-11 will not go a long way toward helping investors make better decisions with respect to such OTC securities. In addition, an issuer could engage in a reverse stock split to raise the price of its securities above $50 and thus escape coverage.

338. *Id.*

339. *Id.* at 11,126.

340. 17 C.F.R. § 240.15c2-11(a)(5) (2005).

341. 1998 Release, *supra* note 154, at 9664-65.

342. 1999 Release, *supra* note 165, at 11,127.

a repository, the broker-dealer would not have an obligation to provide it.[343] Furthermore, subsection (b)(3) of the revised version of Rule 15c2-11 proposed in 1999 would have provided that a broker-dealer would be deemed to have obtained the required issuer information if it obtained the information from an information repository.[344] The Commission stated that acting as a repository "is not a function that we can assume at this time" and that the NASD had similarly declined such a responsibility; however, the Commission did note that it would encourage private-sector initiatives to create a repository that collects information about a substantial segment of issuers subject to Rule 15c2-11, maintains current and accurate information about such issuers, and charges reasonable fees for access to this information.[345]

Had they been adopted, the Commission's proposals would have gone a long way toward making more information about non-reporting Pink Sheets issuers available to investors. First, the actual amount of information would have been expanded in many helpful ways. Second, the elimination of the piggyback provision and the creation of an information repository would have made it much easier for investors to actually obtain information. Furthermore, the proposals would have made it easier for broker-dealers to obtain the required issuer information, at least to the extent that such information was available on an information repository.

The exclusion of some issuers, such as those with net tangible assets in excess of $10 million, would have been problematic, however, especially with respect to issuers that deregister under Section 12 of the Exchange Act and thereafter begin trading on the Pink Sheets, because these issuers would then be *completely* "dark."[346] Although the Commission's proposals would have helped combat microcap fraud, these exclusions would have meant that many non-reporting Pink Sheets issuers would remain mysterious. Requiring more information about *all* non-reporting Pink Sheets issuers and making that information easily available to investors seems a better approach. Although these goals could be achieved through amendments to Rule 15c2-11, it is likely that the broader goal of making issuers responsible for providing the information—rather than making broker-dealers responsible for finding it—would require wholesale revisions to the structure of Rule 15c2-11. A simpler solution is proposed below.[347]

*3. Amending Rule 12g5-1 to Count Street Name Holders as Record Holders.*— Another possible solution to the current problem would be to amend Exchange Act

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343. *Id.*

344. *Id.* at 11,142.

345. *Id.* at 11,134.

346. *See supra* notes 20-22 and accompanying text. An issuer must register its securities under Section 12(g) of the Exchange Act if, among other things, it has more than $10 million in assets. Although an issuer could take steps to reduce the number of its record shareholders below 300 and then deregister under Section 12(g), it obviously would not also want to reduce its assets below $10 million. Assuming that its assets remained at $10 million or more, a former Section 12(g) registrant would escape Rule 15c2-11 completely under the Commission's 1999 proposal. *See* 1999 Release, *supra* note 165, at 11,127.

347. *See infra* notes 357-58 and accompanying text.

Rule 12g5-1 to explicitly count "street name" holders as holders of record for purposes of Section 12(g). As discussed above, the current scheme only counts record shareholders (for the most part, those that hold actual stock certificates) and banks and brokerage firms as "record" holders, leading to substantial undercounting of the "true" number of beneficial shareholders in many companies.[348] If all shareholders were counted, many companies would be prevented from deregistering under Section 12(g) because they would be deemed to have more than 300 shareholders.

In July 2003, several institutional investors filed a petition with the Commission requesting just such a change.[349] In this petition, the applicants argued that Rule 12g5-1 is outdated:

> The 38 years since Rule 12g5-1 was adopted have witnessed monumental changes in clearing and settlement procedures. The transformation of clearing and settlement procedures have [sic] caused, among many other things, a dramatic increase in the percentage of beneficial owners holding equity securities in street name. In contrast to conditions that prevailed in 1965, it is now unusual for a beneficial owner to appear on the corporate books as a holder of record or hold a stock certificate. As a result, Rule 12g5-1 fails to properly effectuate the Congressional intent expressed in Section 12 or the policy goals of the Exchange Act.[350]

Citing several examples of companies that had deregistered under Section 12(g) because they had fewer than 300 record shareholders (although some of them admitted having thousands of beneficial shareholders), and discussing in detail the rise of street name ownership since 1964, the petitioners argued that complete termination of Exchange Act reporting requirements for issuers that "go dark" would mean the loss of the "disinfecting benefits of public disclosure" that "enlighten these issuers' footsteps."[351] Instead, the petitioners argued, if relief from some aspects of SOX was necessary for small issuers, the Commission should continue "tailoring disclosure obligations to [the] special circumstances" of small companies.[352]

Despite this observation, if this proposal were adopted, companies that fled the Exchange Act after SOX would find themselves in exactly the same position that they were before: as an Exchange Act reporting company subject to the whole panoply of new SOX requirements.[353] SOX did not create any middle ground for these

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348. *See supra* notes 26-33 and accompanying text.

349. Nelson Petition, *supra* note 28.

350. *Id.*; *see also* MORGENSTERN & NEALIS, *supra* note 7, at 23 (noting that when Rule 12g5-1 was enacted "[t]he reasonable regulatory assumption was that 300 holders of record would be approximately equal to 300 beneficial owners" (footnote omitted)).

351. Nelson Petition, *supra* note 28.

352. *Id.*

353. Another objection to the petitioners' arguments is that perhaps 500 should not be the "magic number" for Exchange Act registration if street name holders are included. As noted above, Section 12(g) was enacted in 1964. Given that the population of the United States and the percentage of households that own stock have both increased substantially since then, perhaps some

companies; they either agree to comply with the new rules or try to find a way to avoid them, such as by going private.[354] Although the Commission has recognized that smaller companies should shoulder a somewhat reduced disclosure burden in light of their often limited resources, such as by adopting Regulation S-B and by establishing its Advisory Committee on Smaller Public Companies[355] to study and recommend further changes for small public companies, there currently are few provisions in SOX or related Commission rules that make such a distinction. Doing so would likely require additional Congressional action, or at least very substantial revisions to the many Commission rules that have been adopted pursuant to SOX.

*4. Requiring the Pink Sheets and Similar Markets to Register as Self-Regulatory Organizations.*—The Pink Sheets is not registered with the Commission as an exchange, a broker-dealer, a securities information processor, an SRO, or a national securities association.[356] Although the details of market regulation are beyond the scope of this Article and remain under constant reevaluation by the Commission, requiring the Pink Sheets (or any similar organization) to register as an SRO would

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number higher than 500 should be the test for determining whether an issuer is "public." A similar point was made by a subcommittee of the Commission's Advisory Committee on Smaller Public Companies in December 2005 when it made a preliminary recommendation that beneficial holders should be counted for purposes of Section 12(g) of the Exchange Act, but that the number of holders required for registration should be increased from 500 to 1,000. Corporate Governance and Disclosure Subcommittee of the Securities and Exchange Commission Advisory Committee on Smaller Public Companies, Preliminary Recommendations 2 (Dec. 7, 2005), *available at* http://www.sec.gov/info/smallbus/acspc/pr-cgd.pdf (last viewed Feb. 8, 2006). Although few are likely to argue that the Commission was not justified in increasing the measure of an issuer's total assets requiring Section 12(g) registration from $1 million in Section 12(g)(1) to $10 million pursuant to Rule 12g-1, 17 C.F.R. § 240.12g-1 (2005), increasing the number of security holders on some sort of "human inflation" theory is more problematic. Are 500 investors less important today than they were in the past?

354. Indeed, the petitioners' comments appear premised on the notion that Exchange Act reporting is the *only* way for investors to receive sufficient information. For example, in discussing an issuer that had deregistered under Section 12(g), the petitioners stated: "It is a cruel result, and contrary to the purposes of the Exchange Act, to deprive [shareholders] of their last remaining good opportunity to influence the management of their hard-earned investment dollars." Nelson Petition, *supra* note 28, at 6. Other portions of the petition are equally alarmist with respect to the loss of full Exchange Act reporting status:

> No longer confronting the scrutiny of informed investors, management may feel secure in its tenure, to the detriment of the thousands of public investors who can no longer rely on the federal securities laws to protect them from invidious or incompetent management behavior. Without the discipline imposed by public investors, scarce resources are unlikely to be applied by management to their most desirable uses, spreading negative consequences throughout the economy in derogation of the public interest.

*Id.*

355. *See infra* note 357.

356. *See supra* notes 120-21 and accompanying text.

bring at least a few benefits. First, it would subject it to Commission oversight and regulation. Second, it would require that all rules that the Pink Sheets proposes to adopt or amend be subject to public comment, a process that may result in better rules.

*5. Creating a New Category of Issuers.*—A new category of issuers should be created: issuers that are not Section 12 registrants, but whose securities are quoted with some specified level of regularity in markets like the Pink Sheets and that have taken some steps to facilitate a market for their securities. If this approach were adopted, it would have the benefit of flexibility. As discussed above, the Exchange Act and SOX are largely "one size fits all" and impose many requirements that are ill-suited to many Pink Sheets issuers, particularly small companies.[357] Creating a separate set of disclosure requirements would allow the Commission to tailor requirements carefully to ensure a sufficient level of information, yet not require detailed disclosures that would overburden these issuers and result in negligible benefits to investors.

This result could be achieved by amending Exchange Act Rule 12g5-1. Instead of defining the number of an issuer's holders "of record" for purposes of Section 12(g) of the Exchange Act solely in terms of record holders (as that term was understood in 1964) or solely in terms of beneficial holders (as proposed by the institutional investors discussed above), the Commission could amend the rule to provide for a novel two-tier approach. Specifically, if an issuer's securities were listed on NASDAQ, the OTCBB, or another market that requires an issuer to register such securities under Section 12(g), then it would count only record holders. This would mean that all such issuers would be Section 12(g) registrants. However, the rule could further provide that an issuer that has fewer than 500 (or, for purposes of deregistration, 300) record holders and has taken affirmative steps, or whose insiders have taken such steps, to cause that class to be quoted on a market like the Pink Sheets that does not require Section 12(g) registration would be required to count the number of its beneficial holders—*unless* the issuer complies with the reduced reporting requirements described in this Article. Therefore, non-reporting Pink Sheets issuers would be required to comply with reporting requirements even though

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357. The Commission recently established an advisory committee to study the impact of SOX and other federal securities laws on small public companies. One area that this committee, the Securities and Exchange Commission Advisory Committee on Smaller Public Companies, will study is "corporate disclosure and reporting requirements and federally imposed corporate governance requirements for smaller public companies, including differing regulatory requirements based on market capitalization, other measurements of size or market characteristics." Press Release, Sec. and Exch. Comm'n, SEC Establishes Advisory Comm. to Examine Impact of Sarbanes-Oxley Act on Smaller Public Co.'s (Dec. 16, 2004), *available at* http://www.sec.gov/news/press/2004-174.htm. The committee is to recommend changes in laws and regulations by April 2006. Securities and Exchange Commission Advisory Committee on Smaller Public Companies, Master Schedule 5 (Jan. 24, 2006), *available at* http://www.sec.gov/info/smallbus/acspc/acspc-mastersched.pdf. Because the committee is an advisory committee pursuant to the Federal Advisory Committee Act, 5 U.S.C. App. 1, it has no rulemaking authority. Instead, the decision whether to adopt any of the committee's recommendations rests with the Commission.

they have fewer than the requisite number of "traditional" record holders under Section 12(g). At the same time, it would spare them from full blown Section 12(g) registration and give them an incentive to comply with these reporting requirements so that they do not have to register under Section 12(g). Exchange Act Section 12(g)(5) specifically provides that the "Commission may . . . define by rules and regulations the term[] . . . 'held of record' as it deems necessary or appropriate in the public interest or for the protection of investors in order to prevent circumvention of the provisions of this subsection."[358]

### *F. Possible Disclosure Venues*

Once it is decided exactly what information should be required of non-reporting Pink Sheets issuers and how to implement those requirements, the next question is *where* that information should be available. As an initial matter, it would be wise to require that this information be collected in a centralized location; requiring each issuer to post information on its own website would seem unworkable from a compliance monitoring standpoint and would relegate an investor to as many different websites as he has Pink Sheets investments, losing the "one-stop shopping" advantage of the other approaches discussed below.[359]

On the other hand, requiring issuers or broker-dealers to post the information on their own websites[360] may be a good interim solution, as the exact requirements of many of the other approaches discussed below would likely take some time to develop and implement. This interim solution could be coupled with a requirement that each issuer periodically certify to the appropriate regulatory or other body, whether that would be the Pink Sheets, the NASD, or the Commission, that it has posted the required information.[361]

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358. 15 U.S.C.A. § 78*l*(g)(5) (West 2005).

359. Also, a company website will often contain "soft" information that could easily be confused with the "hard" information that is contained in periodic reports.

360. Specifically, if a broker-dealer recommends a transaction in an issuer's securities and that issuer has not posted the required information on its own website, the broker-dealer should be required to post the information on the broker-dealer's website. Although Rule 15c2-11 requires a broker-dealer in most cases to have certain information in its files, this information often does not reach the investor. *See supra* notes 154-55 and accompanying text. Whatever approach is undertaken to remedy this problem will also entail the broker-dealer having information about the issuer before recommending a transaction in the issuer's securities. If the broker-dealer were required to post the information on its website when the issuer has not, the investor is much more likely to be able to access the information than it is under current practice.

361. A related provision should require broker-dealers to certify annually that they have sufficient procedures in place to ensure that the required issuer information has been made available for any Pink Sheets stocks that they recommend to customers. *Cf.* Order Approving NASD Proposed Rule Change Relating to Chief Executive Officer Certification and Designation of Chief Compliance Officer, Exchange Act Release No. 34-50347, 69 Fed. Reg. 56,107 (Sept. 17, 2004) (approving NASD rule that requires the CEO of each NASD member firm to certify annually that the firm has in place policies and procedures reasonably designed to achieve compliance with

*1. Pink Sheets Website.*—Following the adoption of its Disclosure Policy, the Pink Sheets has allowed issuers to post the information required by the policy directly on the Pink Sheets website. This approach has the advantage of putting all Pink Sheets issuers' information in the same place and also appears relatively easy for issuers.

*2. EDGAR.*—Another obvious possible venue is the Commission's EDGAR system, which is used for all documents that the Commission requires to be filed electronically, including nearly all Exchange Act reports.[362] There is much to admire about the EDGAR system, particularly since all documents filed via EDGAR are available on the Commission's website soon after they are filed and can be easily retrieved, free of charge. Moreover, all Exchange Act issuers' documents are available in one place.[363] However, it is likely that many issuers, particularly small ones, will object to the expense involved in converting their reports, which are often done in standard word processing or spreadsheet programs, into the EDGAR format. Suffice it to say for purposes of this Article that one cannot simply press a button and have a document converted into EDGAR-ready format; rather, it requires specialized software and knowledge, which leads most filers to outsource the function to a third party such as a financial printer or a law firm. This outsourcing, of course, comes at a price.

*3. SEDAR.*—One intriguing approach comes to us from Canada: the System for Electronic Document Analysis and Retrieval ("SEDAR") system.[364] SEDAR was established in 1997 "to make Canadian public securities filings easily accessible to all."[365] It is essentially akin to the Commission's EDGAR system; all Canadian public companies electronically file required Canadian Securities Administrators documents and, in many cases, the documents that they file with Canadian stock exchanges, on SEDAR. These documents are usually available to the public on the SEDAR website within a day after they are filed.[366] Unlike EDGAR, filing a document on SEDAR is relatively easy because all documents must be filed in Adobe PDF format, software which is widely available and does not require any special expertise for conversion.[367] Moreover, it appears that the hardware requirements and

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applicable rules and regulations, including federal securities laws).

362. Regulation S-T, 17 C.F.R. §§ 232.10-.501 (2005), contains the Commission's rules with respect to the EDGAR system. Rule 101 of Regulation S-T specifies which documents must be filed electronically, which may be, but are not required to be, filed electronically, and which can be filed only in paper format. *Id.*

363. *See generally* SEC, Search the EDGAR Database, http://www.sec.gov/edgar/searchedgar/webusers.htm (last visited Jan. 17, 2006).

364. *See generally* SEDAR Home Page, http://www.sedar.com/homepage_en.htm (last visited Jan. 17, 2006).

365. *Id.*

366. SEDAR Frequently Asked Questions, http://www.sedar.com/sedar/faq_en.htm (last visited Jan. 17, 2006).

367. *See id.* "In developing SEDAR, the Canadian Securities Administrators tried to balance the needs of filers seeking a way to efficiently file their documents on SEDAR against the desire to make the documents easily available to the public." *Id.*

initial software set-up to become a SEDAR filer are not unreasonably demanding. Although SEDAR does charge issuers fees for filing documents,[368] whereas EDGAR does not,[369] it is likely that the ease of SEDAR filing outweighs this cost.

SEDAR is also easy for investors to use because it requires only Internet access. The SEDAR website features profiles of each listed issuer, arranged in alphabetical order.[370] These profiles contain general information about each issuer.[371] From that page, one can click a link to access all of the issuer's SEDAR filings, in reverse chronological order. These documents (at least those filed since September 1999) are in PDF format, meaning that they look the same as the original "hard copies" of the documents, and are searchable.[372]

In its releases concerning proposed amendments to Rule 15c2-11, the Commission suggested establishing a "repository" to collect and maintain current and accurate information about issuers subject to Rule 15c2-11.[373] Today, it seems obvious that this repository would be Internet-based. Moreover, although this Article certainly does not comment on any technical requirements of such a website, SEDAR does present an attractive model, in that it is easy to use for both issuers and investors, it is free for investors and reasonably priced for issuers, and it retains EDGAR's centralized location advantage. Moreover, if something like SEDAR were used as an information repository for Pink Sheets issuers and were overseen by regulators (as opposed to the Pink Sheets or another private entity), it would have stability and regulatory advantages that may be lacking in a purely private-run enterprise. As such, in establishing the information repository that the Commission has long envisioned, one need look no further than SEDAR for a good template.

### *G. Disadvantages*

In 1998 and 1999 when the Commission proposed increasing the amount of information required under Rule 15c2-11 and eliminating the piggyback exception, the result was a howl of protest from the brokerage community, which complained that such requirements would dry up the Pink Sheets market.[374] If one accepts that

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368. SEDAR filers are subject to two types of fees. The first is an annual "continuous disclosure fee" which ranges from $495 (Canadian) for mutual funds to $1595 for "multi jurisdiction issuers." The second is a per-document fee, which varies depending on the nature and length of the document. *See generally* SEDAR Filing Service Charges, http://www.sedar.com/pdf_files/CDSfees_E.pdf (last visited Jan. 17, 2006). In addition, the license fee for the SEDAR software is $390, both initially and annually.

369. This should not be confused with the fact that some documents, such as Securities Act registration statements, require filing fees; these fees predate EDGAR and have nothing to do with the fact that the document is filed via EGDAR.

370. *See* SEDAR, Public Companies: A, http://www.sedar.com/issuers/company_issuers_a_en.htm (last visited Jan. 17, 2006).

371. *Id.*

372. *Id.*

373. *See supra* notes 340-45 and accompanying text.

374. *See supra* note 322.

claim, it would be naïve to believe that the approach advocated in this Article would not result in a similar protest. However, creating an information repository and the capability to monitor compliance by issuers could free broker-dealers from the obligation to independently determine that the required information is publicly available.

Another likely objection will be from issuers that would be subject to a new disclosure regime—particularly if they took steps to go private and avoid the Exchange Act and SOX. The response to this argument is that they should not be allowed to have their cake and eat it too. If they wish to remain "dark," they may do so, especially since the Pink Sheets is not structured so that an issuer could prevent its securities from being quoted there. However, if an issuer or its insiders want to gain the benefit of a market for the issuer's stock, then the issuer should be required to make the sacrifice of public disclosure of at least a modest amount of information.[375]

Another potential problem is that many issuers may simply refuse to comply.[376] But this is also true for many Exchange Act companies that fail to file required reports. It is also true that broker-dealers may not utilize Rule 15c2-11 if the information required by that rule cannot be obtained. The response, then, would be to prohibit trading in a company's securities if it is required to disclose information but fails to do so.

It should also be emphasized that the approach advocated by this Article would not by itself result in any regulatory review of the disclosures an issuer makes, unlike Exchange Act disclosures[377] and Securities Act registration statements. Unless the Commission or some other regulatory body were to assume that task, one solution to this problem would be to ensure that investors understand that the information disclosed by an issuer has not been independently reviewed by regulators, as suggested in the following section. Another solution is to require standardized "fill-

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375. One should also keep in mind that many issuers have bank financing, the terms of which ordinarily will require regular financial reports to the lender. As such, requiring that this information also be made public will likely not be unduly burdensome to many issuers. However, as discussed in *supra* note 302, perhaps the deadlines under the Exchange Act and the Pink Sheets Disclosure Policy for annual and quarterly financial statements (ninety days and forty-five days, respectively) should be extended.

376. Consider the attitude of one Pink Sheets company:

> At the other end of that spectrum: Anderson-Tully, for which investors are currently bidding $175,000 a share. Because it has fewer than 500 [record] shareholders, Anderson-Tully doesn't file financial reports with the Securities and Exchange Commission. The company shares financial information only with shareholders. "We aren't going to distribute the information publicly" to anyone who calls up and asks for it before they invest, explains Chip Dickinson, Anderson-Tully's president.

Opdyke, *supra* note 123.

377. For example, 15 U.S.C.A. § 7266 (West 2005), added by Section 408 of SOX, requires the Commission to review, at least once every three years, disclosures made by Exchange Act issuers that are listed on a national securities exchange or NASDAQ "on a regular and systematic basis for the protection of investors."

in-the-blanks" forms, which should be particularly helpful for small issuers that have not previously been subject to securities disclosure requirements and that may not engage counsel for assistance in completing the forms.[378]

### *H. A Final Note: Investor Warnings*

The approach advocated by this Article would not require Pink Sheets companies to be full-fledged Section 12(b) or 12(g) registrants, nor would it require the Pink Sheets to adopt any quantitative or qualitative listing criteria. Although it would result in more information about Pink Sheets issuers that have voluntarily availed themselves of the capital markets being available to the public, it would not subject these companies to the many investor-oriented provisions of the Exchange Act, particularly as modified by SOX.

Will this confuse investors? Will investors be able to distinguish between "true" public companies and those that only seem to be? In a sense, these questions are unimportant because many investors in Pink Sheets companies may currently be unaware of this distinction. Nonetheless, it seems that if the approach advocated by this Article, or some similar approach, were adopted, the confusion would intensify. An issuer that now is required to publish documents that resemble Exchange Act reports in some superficial way may seem more like a public company than one that does not publish much information about itself at all. For this reason, another requirement that should be implemented is a "warning sign" to Pink Sheets investors.

What should be contained in this warning? It essentially should contain a statement that the issuer is not subject to the Exchange Act and the many investor protections that it contains. For example, the warning could state the following:

> ***Attention Investors***: Our company does not have securities that are registered under Section 12(b) or Section 12(g) of the Securities Exchange Act, nor does it have securities that are traded on a market that imposes listing criteria, investor-oriented protections or corporate governance requirements. As such, you should be aware that we are not subject to the following requirements that are imposed on such public companies (among others). Although we may *voluntarily* observe these requirements, we could discontinue doing so at any time:
>
> - We are not required to file Forms 10-K, 10-Q, and 8-K and meet the detailed disclosure provisions of those forms. The forms that we file are much less detailed and less stringent.
>
> - We are not required to file audited financial statements. Instead, we

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378. Of course, this is no guarantee of compliance. A humorous example was given by Makens and Barnes: "The states have experienced a great deal of difficulty with officers of issuers attempting to fill out the forms without advice of counsel, with the result [of this] answer . . . List in order of importance the factors which the Company considers to be the most substantial risks to an investor in this offering . . . . Answer: NONE." Makens & Barnes, *supra* note 287, at 241, *379.

may file "reviewed" financial statements.

- If we file audited financial statements, our CEO and CFO are not required to personally certify the accuracy of those financial statements.
- We are not required to have any "independent" members on our board of directors.
- We are not required to have an audit committee, a compensation committee, or a nominating committee whose members are "independent" of the company.
- We are not required to have a "financial expert" on our audit committee.
- Our accountants are not required to be "independent."
- We are not required to furnish an internal controls report.
- We are not required to have a code of ethics.
- Our shareholders, including insiders, are not subject to Section 13(d) or Section 16 of the Securities Exchange Act.
- We are not subject to the rules concerning the solicitation of proxies under Section 14 of the Securities Exchange Act.
- We are not required to maintain any level of liquidity for our shareholders.
- Neither the Securities and Exchange Commission nor any other regulatory body reviews the information that we disclose to determine that it is accurate or adequate.

This is not a complete list of the differences between our company and public companies. You should be aware that all investments entail risk. However, because our company is not subject to the requirements listed above, as well as others, an investment in our company may subject you to significantly more risk than other investments.[379]

These warnings should be included in whatever periodic reports may end up being required of Pink Sheets issuers. They could also be delivered to investors in much the same way that the penny stock rules require a Schedule 15G to be delivered

379. Obviously, such a warning would be tailored to the precise nature of the disclosure requirements imposed upon Pink Sheets issuers.

to investors;[380] alternatively, broker-dealers could be required to refer investors to the warnings included in an issuer's reports whenever recommending a transaction in that issuer's securities. Furthermore, for issuers whose securities are involuntarily traded on the Pink Sheets and that choose not to comply with any disclosure requirements, the warning should also include information describing the dangers of investing in an issuer for which little public information is available.

## CONCLUSION

A curious result of the Exchange Act's structure is that issuers with few record shareholders but whose securities are quoted on a market like the Pink Sheets are able to escape the detailed periodic disclosure requirements of the Exchange Act even if they have several thousand beneficial shareholders. Given the many developments since Section 12(g) was adopted more than forty years ago, current rules are not sufficient to ensure that adequate information about these issuers is available to investors. Current rules have also created a perverse incentive for many public companies to "go dark" in order to avoid the requirements of the Exchange Act and its ever-expanding requirements. The result is a trading market for many securities about which little is known outside Internet "chat rooms" and other unreliable sources.

This Article has pointed the way toward a solution to this problem that will provide more information to investors without unduly burdening issuers and their markets. Of course, many issuers, particularly those who have not voluntarily created a market for their securities, will object to any disclosure requirements whatsoever. It is true that we should not penalize such recalcitrant issuers, particularly if competitively sensitive business information must be disclosed. In that case, it would seem sufficient to adequately warn investors of the dangers that they face when they invest blindly. On the other hand, if an issuer or its insiders voluntarily takes steps to avail themselves of the benefits of having a market for their securities, it seems only fair that other shareholders and prospective investors be put on a more level informational playing field. Doing so will not only benefit investors, but it will also benefit issuers.

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380. *See supra* note 114.

# IN *BOOKER*'S SHADOW: RESTITUTION FORCES A SECOND DEBATE ON HONESTY IN SENTENCING

MELANIE D. WILSON*

## INTRODUCTION

> [W]e call in a jury of the people to decide all controverted matters of fact, because to that investigation they are entirely competent, leaving thus as little as possible, merely the law of the case, to the decision of the judges. And true it is that the people, especially when moderately instructed, are the only safe, because the only honest, depositories of the public rights, and should therefore be introduced into the administration of them in every function to which they are sufficient.[1]

In 1823, Thomas Jefferson expressed these thoughts to Adamantios Coray, a Greek patriot, who had written to Jefferson requesting advice about a national government for newly liberated Greece.[2] In his response letter to Coray, Jefferson emphasized the significance of a constitution and specifically recognized the importance of a jury, as compared to the limited role of the judiciary.[3] Sadly, the jury protections described by Jefferson have been eroded. Today, persons accused of crimes are not afforded the safeguard intended by our forefathers.

This Article analyzes the United States Supreme Court's landmark decision in *United States v. Booker*,[4] which held that the United States Sentencing Guidelines ("Federal Guidelines") violated the Sixth Amendment's guarantees of trial by jury and proof of guilt beyond a reasonable doubt.[5] *Booker* is examined in an effort to determine whether its underlying principles require the conclusion that the Mandatory Victims Restitution Act of 1996 ("MVRA"),[6]

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* Associate Professor, John Marshall Law School, Atlanta; former assistant United States attorney, U.S. Attorney's Office for the Northern District of Georgia (2001-2005), U.S. Attorney's Office for the Middle District of Georgia (1999-2001); J.D., University of Georgia School of Law.

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1. Letter from Thomas Jefferson to A. Coray (Oct. 31, 1823), *in* The Thomas Jefferson Papers Series 1, General Correspondence, 1651-1827 (on file with the Library of Congress in the Thomas Jefferson Papers).

2. *Id.*

3. *Id.*

4. 543 U.S. 220 (2005).

5. *See id.* at 243-44; *see also* U.S. CONST. amend. VI ("[T]he accused shall enjoy the right to a speedy and public trial, by an impartial jury . . . .").

6. Congress passed the MVRA in 1996 as part of the Antiterrorism and Effective Death Penalty Act of 1996 ("AEDPA"), Pub. L. No. 104-132, §§ 202 and 204, 110 Stat. 1214 (codified at 18 U.S.C. § 3663A-3664). The Federal Guidelines also contain a provision addressing restitution, but the Guidelines refer back to 18 U.S.C. §§ 3663-3664. *See* U.S. SENTENCING GUIDELINES MANUAL § 5E1.1 (2004) [hereinafter USSG].

which governs restitution for federal crimes, also breaches the Sixth Amendment. The MVRA expressly requires that judges, rather than juries, decide issues of restitution.[7] The MVRA also grants judges broad post-conviction discretion that often results in orders of restitution that are much harsher than a defendant could have reasonably predicted from the indictment, the evidence presented at trial, or the defendant's admission of guilt during the plea colloquy.[8]

Federal prosecutors and defenders eagerly awaited the January 2005 decision in *Booker*, with a mixture of anticipation and trepidation. *Booker* was expected by some to dramatically change the entire system of charging and sentencing criminal defendants in the federal courts.[9] Legal scholars predicted that if the Court ruled that the Federal Guidelines violated the Sixth Amendment, then every fact with any bearing on a defendant's potential sentence might need to be charged in the indictment and later presented to a petit jury for consideration.[10] This anticipated procedure would be far different from the process already in use under which a jury determined whether or not a defendant had committed certain statutorily-defined aspects of a crime (or the defendant admitted those portions in a plea) and then (in a subsequent hearing after the court conducted a separate pre-sentence investigation),[11] the sentencing judge made additional findings by a preponderance-of-the-evidence standard.[12]

In preparation for the Court's ruling in *Booker*, the Department of Justice ("DOJ" or "the Department") implemented policy changes that altered the way crimes were to be charged, indicted, and pursued through sentencing.[13] As part of this new policy, line prosecutors were told to include a section of "Special Findings" in every indictment to spell out any fact that under the Federal Guidelines could result in a sentencing enhancement.[14] The indictment with the

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7. *See* 18 U.S.C. § 3664(e) (2000).

8. *See generally id.*

9. *See* Jason Amala & Jason Lavrine, *An Exceptional Case: How Washington Should Amend Its Procedure for Imposing an Exceptional Sentence in Response to* Blakely v. Washington, 28 SEATTLE U. L. REV. 1121, 1122 (2005) (discussing how legislators, judges, prosecutors, and defense attorneys scrambled to find a solution to the Supreme Court's pre-*Booker* decision in *Blakely v. Washington*).

10. *See, e.g.*, Carmen D. Hernandez, Fanfan *and* Blakely *Decisions Could Cause Major Changes*, THE NATIONAL ASSOCIATION OF CRIMINAL DEFENSE LAWYERS NEWS (Champion), Dec. 2004, at 6, *available at* http://www.nacdl.org/public.nsf/freeform/championmag?OpenDocument (follow "Search All Public Articles . . ." hyperlink and search for "Cause Major Changes").

11. Although on behalf of the court, the presentence investigation is conducted by the United States Probation Office.

12. Sometimes a court's additional findings greatly increased a defendant's period of incarceration and amount of restitution; occasionally, the findings decreased the sentence.

13. *See* Memorandum from James Comey, Deputy Attorney General, to All Federal Prosecutors (July 2, 2004), *available at* http://www.usdoj.gov/dag/readingroom/blakely.htm.

14. This instruction to line prosecutors was derived from Mr. Comey's Memo of July 2, 2004. *See id.* The author of this Article received this instruction as a line prosecutor in the Northern District of Georgia.

Special Findings section was then presented to a federal grand jury, and the grand jury decided whether or not there was probable cause to believe that the defendant had committed the substantive offense and whether the Special Findings applied to the defendant.

It turns out *Booker* was not the process-altering decision most federal criminal lawyers anticipated. Although it did hold that the Sixth Amendment applies to the Federal Guidelines, it was a two-part majority decision. The second part proposed a "remedy" for the invalid nature of the Guidelines and, thereby, avoided any monumental transformation in the way federal criminal cases needed to be charged, tried, and sentenced.[15] After *Booker*, the Department immediately returned to its old charging and sentencing practices. As a practical matter, *Booker* altered very little in the sentencing process. Perhaps the post-*Booker* mantra in the U.S. Attorney's Office, Northern District of Georgia, captures it best; after *Booker*, "nothing has changed."[16]

The *Booker* decision spoke to sentencing enhancements that increase a defendant's period of incarceration pursuant to the Federal Guidelines and the Sentencing Reform Act of 1984 ("SRA"),[17] which spawned the Guidelines. The Court was not presented with, and did not reach, the issue of restitution, which is governed by the MVRA. Therefore, the Supreme Court did not decide whether the process for determining restitution pursuant to the MVRA also violates the Sixth Amendment.

This Article employs a *Booker*-type analysis to show that the MVRA violates the Sixth Amendment and that the circuit courts are misapplying the principles of *Booker* in concluding that the MVRA remains unaffected by that decision. The Article ultimately urges Congress to remedy the constitutional weaknesses in the MVRA and encourages the Department to lead the way in securing honesty in charging and sentencing by returning to its pre-*Booker* policies. Finally, this Article concludes that the federal sentencing courts and appellate courts can help preserve defendants' Sixth Amendment rights by strictly adhering to the principles established in the 1990 decision, *Hughey v. United States*.[18] In *Hughey*, the Supreme Court held that a defendant may only be ordered to make restitution for losses proximately resulting from the offenses for which he is convicted, not for additional losses.[19]

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15. Professor Paul Kirgis recently described the *Booker* decision as one "containing a fundamental internal inconsistency." *See* Paul F. Kirgis, *The Right to a Jury Decision on Sentencing Facts After* Booker*: What the Seventh Amendment Can Teach the Sixth*, 39 GA. L. REV. 895, 900 (2005). Professor Kirgis concluded, "As a matter of logic, . . . [*Booker*] simultaneously confers and negates the right to a jury decision on sentencing facts." *Id.* at 925.

16. In the days after *Booker*, federal prosecutors received much guidance from the Department of Justice in Washington, D.C., and internally from the management teams in the U.S. Attorney's Offices. This mantra originated from such meetings in the Northern District of Georgia, several of which the author attended.

17. *See* 18 U.S.C. § 3551 (2000); 28 U.S.C. § 991 (2000).

18. 495 U.S. 411 (1990).

19. *Id.* at 417.

Part I of this Article reviews the Sixth Amendment and the ideals underlying it and briefly looks at the Supreme Court's holding in Part One of *United States v. Booker*.[20] Part II examines the MVRA and explores the unfair surprise and accompanying lack of honesty in sentencing that defendants often experience as a result of judges deciding issues of fact in support of restitution orders, as required by the MVRA. Part II also considers whether the restitution process mandated by the MVRA violates Rule 11 of the Federal Rules of Criminal Procedure. Part III analyzes *Booker* and its forerunners, *Apprendi v. New Jersey*[21] and *Blakely v. Washington*,[22] and focuses on how these cases impact the MVRA. Part III also considers whether or not restitution is an "element" of a criminal offense, concludes that restitution probably is, and questions why federal appellate courts are, nevertheless, refusing to apply the Sixth Amendment to restitution. Finally, Part III discusses the fact that the appellate courts have uniformly held that the MVRA is immune from the Sixth Amendment and exposes significant flaws in the reasoning supporting that conclusion. The flaws analyzed include the appellate courts' incorrect assumptions regarding the "statutory maximum" within the MVRA and the legal consequences of the unbounded discretion granted judges under the MVRA to find facts in support of orders of restitution. Part IV urges Congress, the Department of Justice, and the federal courts to encourage honesty in sentencing, which will, in turn, preserve defendants' Sixth Amendment rights.

## I. THE SIXTH AMENDMENT AND THE DECISION IN *UNITED STATES V. BOOKER*

### *A. The Sixth Amendment*

The Sixth Amendment of the United States Constitution provides that in all criminal prosecutions, "the accused shall enjoy the right to a speedy and public trial, by an impartial jury. . . ."[23] The Supreme Court has repeatedly interpreted the Sixth Amendment to confer a constitutional right to: 1) have a jury trial on all elements of a crime[24] and 2) be proven guilty beyond a reasonable doubt.[25]

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20. 543 U.S. 220 (2005).

21. 530 U.S. 466 (2000).

22. 542 U.S. 296 (2004).

23. *See* U.S. CONST. amend. VI.

24. *See Booker*, 543 U.S. at 230 (noting that the "[Federal] Constitution gives a criminal defendant the right to demand that a jury find him guilty of all the elements of the crime with which he is charged" (citation omitted)); *see also* Jones v. United States, 526 U.S. 227, 232 (1999) ("[E]lements [of a crime] must be charged in the indictment, submitted to a jury, and proven by the Government beyond a reasonable doubt."); *In re* Winship, 397 U.S. 358, 361 (1970) (noting that the government "must convince the trier [of fact] of all the essential elements of guilt" (citation omitted)).

25. *See Booker*, 543 U.S. at 230 ("[T]he Constitution protects every criminal defendant 'against conviction except upon proof beyond a reasonable doubt.'" (quoting *In re Winship*, 397 U.S. at 364)); *see also Apprendi*, 530 U.S. at 478 (noting that "well founded is the . . . right to have

*1. The Jury Requirement.*—The constitutional mandate that a jury, not a judge, determine that an accused is guilty of each element of a crime is designed to "guarantee[] that the jury [will] . . . stand between the individual and the power of the government."[26] "The Framers of the Constitution understood the threat of 'judicial despotism' that could arise from 'arbitrary punishments upon arbitrary convictions' without the benefit of a jury in criminal cases."[27] The Supreme Court has declared repeatedly that "trial by jury has been understood to require that '*the truth of every accusation*, whether preferred in the shape of indictment, information, or appeal, should afterwards be confirmed by the unanimous suffrage of twelve of [the defendant's] equals and neighbours.'"[28]

*2. The Burden of Proof.*—The proof-beyond-a-reasonable-doubt standard of guilt is also a vital protection guaranteed by the Sixth Amendment[29] that "safeguards [citizens] from dubious and unjust convictions, with resulting forfeitures of life, liberty and property."[30] As the Supreme Court acknowledged decades ago, the heightened standard plays a "vital role in our criminal procedure."[31] It protects the interests of the accused, which are of "immense importance, both because of the possibility that he may lose his liberty upon conviction and because of the certainty that he would be stigmatized by the conviction."[32] This standard also "command[s] the respect and confidence of the community in applications of the criminal law."[33] Such a standard gives "every

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the jury verdict based on proof beyond a reasonable doubt"); *In re Winship*, 397 U.S. at 362 ("[I]t has long been assumed that proof of a criminal charge beyond a reasonable doubt is constitutionally required.").

26. *Booker*, 543 U.S. at 237.

27. *See id.* at 238-39 (quoting THE FEDERALIST NO. 83, at 499 (Alexander Hamilton) (Clinton Rossiter ed., 1961)); *see also Blakely*, 542 U.S. at 308 ("[T]he very reason the Framers put a jury-trial guarantee in the Constitution is that they were unwilling to trust [the] government to mark out the role of the jury.").

28. *Apprendi*, 530 U.S. at 477 (alteration in original) (quoting 4 W. BLACKSTONE, COMMENTARIES ON THE LAWS OF ENGLAND 343 (1769)); *see also Blakely*, 542 U.S. at 301 (noting that the "truth of every accusation" should be confirmed by the unanimous suffrage of twelve and that "an accusation which lacks any particular fact which the law makes essential to the punishment is . . . no accusation within the . . . law" (citation omitted)). The Supreme Court also declared that a defendant should be able to "discern from the statute of indictment what maximum punishment conviction under that statute could bring." *Apprendi*, 530 U.S. at 483 n.10.

29. "Proof beyond a reasonable doubt . . . is proof of such a convincing character that you would be willing to rely and act upon it without hesitation in the most important of your own affairs." ELEVENTH CIRCUIT PATTERN JURY INSTRUCTIONS, CRIMINAL, General Instruction 3, at 8 (2003). Furthermore, it is "the measure of persuasion by which the prosecution must convince the trier of all the essential elements of guilt." *In re Winship*, 397 U.S. at 361 (citing C. MCCORMICK, EVIDENCE § 321, at 681-82 (1954)).

30. *In re Winship*, 397 U.S. at 362 (citing Davis v. United States, 160 U.S. 469, 488 (1895)).

31. *Id.* at 363.

32. *Id.*

33. *Id.* at 364.

individual going about his ordinary affairs . . . confidence that his government cannot adjudge him guilty of a criminal offense without convincing a proper factfinder of his guilt with utmost certainty."[34] These interpretations of the Sixth Amendment laid the foundation for Part One of the U.S. Supreme Court's decision in *Booker*.

### *B. The Decision in* United States v. Booker

In January, 2005, the Supreme Court issued a landmark Sixth Amendment decision, *United States v. Booker*.[35] The *Booker* decision includes a two-part majority opinion,[36] holding first that the Sixth Amendment applies to the Federal Guidelines,[37] and, second, that the portions of the federal sentencing statute that made the Federal Guidelines mandatory "must be severed and excised."[38] The Court in *Booker* excised two portions of the sentencing statute after determining that those two provisions, which made the Federal Guidelines mandatory, caused the Guidelines as a whole to violate the Sixth Amendment.[39]

The *Booker* decision considered whether the Sixth Amendment applied to the Federal Guidelines. It did not address restitution or the Sixth Amendment's impact on the Mandatory Victims Restitution Act, which governs restitution.[40]

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34. *Id.*

35. 543 U.S. 220 (2005). The case comprised two separate criminal appeals that the Court addressed in one opinion after certiorari was granted in each. *Id.* at 229. The defendants were Freddie J. Booker and Ducan Fanfan. In Booker's case, the jury had found Booker guilty of possession with intent to distribute at least fifty grams of cocaine base, enough to authorize a sentence of between 210 and 262 months of incarceration pursuant to the Federal Guidelines. *Id.* at 227. In the case of Fanfan, the jury had found that he possessed, with intent to distribute, at least 500 grams of cocaine, enough cocaine to support a sentence for seventy-eight months of incarceration pursuant to the Federal Guidelines. *Id.* at 228. In each case, at the subsequent sentencing hearing, the sentencing judge found that the defendant had possessed more drugs than that determined by the jury. *See id.* at 227-28.

36. Justice Stevens wrote Part One in which Justices Scalia, Souter, Thomas, and Ginsburg joined. *See id.* at 225. Part Two of the majority opinion was written by Justice Breyer, in which Chief Justice Rehnquist and Justices O'Connor, Kennedy, and Ginsburg joined. *Id.* at 244.

37. *See id.* at 226-27.

38. *Id.* at 245.

39. *See id.* at 245-46 (finding 18 U.S.C. § 3553(b)(1) (2000) "incompatible with today's constitutional holding" and excising § 3742(3) as well).

40. *See* United States v. Wilson, 350 F. Supp. 2d 910, 928-29 (D. Utah 2005) (noting that *Booker* focused on the Sentencing Reform Act of 1984, not the MVRA, which was enacted separately in 1996, and commenting that *Booker* did not answer whether the MVRA is unconstitutional although the MVRA "requires judicial fact-finding beyond that authorized by the Sixth Amendment").

## II. THE MVRA AND THE LACK OF HONESTY IN SENTENCING

### *A. The MVRA and Current Process*

The Mandatory Victims Restitution Act, or MVRA, governs restitution in federal sentencing.[41] It provides the ground rules for imposing restitution and mandates restitution for certain crimes.[42] It also provides that "[a]ny dispute as to the proper amount or type of restitution shall be resolved by the court by the preponderance of the evidence."[43] Pursuant to the MVRA, after a defendant pleads guilty or is found guilty of a crime, a federal probation officer prepares a pre-sentence report ("PSR"), which includes information about the victims of the defendant's crimes and the amount of restitution purportedly owed to the victims.[44] Often the prosecutor or the victim supplies the probation officer with this information.[45] Once compiled, the information in the PSR is distributed to the federal prosecutor and to the defendant's lawyer.[46] Frequently, the PSR contains information and facts unknown to either the prosecutor or defense counsel, so the lawyers are given an opportunity to object to the findings in the report.[47] After objections are registered, a sentencing hearing is held during which the judge makes findings about how much restitution the defendant owes.[48] The sentencing court then orders the defendant to pay "restitution to each victim

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41. *See generally* 18 U.S.C. §§ 3663, 3663A(a)(1), 3664. Congress passed the MVRA in 1996 as part of the Antiterrorism and Effective Death Penalty Act ("AEDPA") of 1996, Pub. L. No. 104-132, §§ 202 and 204, 110 Stat. 1214 (codified at 18 U.S.C. § 3663A).

42. *See* 18 U.S.C. § 3663A (providing that notwithstanding other provisions of law, a court sentencing a defendant shall order restitution); *see also* United States v. Schulte, 264 F.3d 656, 661 (6th Cir. 2001) (explaining that the MVRA amended the earlier restitution statute, the Victim and Witness Protection Act, and added Section 3663A, which requires restitution for certain crimes). In passing the new restitution provisions, the Senate Committee indicated its desire "that courts order full restitution to all identifiable victims of covered offenses." *Id.* at 661 n.2 (quoting S. Rep. No. 104-179 (1996), at 12, *reprinted in* 1996 U.S.C.C.A.N. 924, 931).

43. 18 U.S.C. § 3664(e).

44. *See* FED. R. CRIM. P. 32(c)(1)(B) (explaining that a probation officer must generally conduct a presentence investigation and submit the accompanying report to the court before the court imposes a sentence and that the report must contain "sufficient information for the court to order restitution"); *see also* 18 U.S.C. § 3664(a) (explaining that the probation officer is to include in the presentence report "information sufficient for the court to exercise its discretion in fashioning a restitution order").

45. *See* 18 U.S.C.§ 3664(d)(1) (explaining that "the attorney for the Government, after consulting . . . with all identified victims, shall promptly provide the probation officer with a listing of the amounts subject to restitution" and that the probation officer shall provide certain notice to the victims to allow them an opportunity to submit information concerning the amount of their losses).

46. *See id.* § 3664(b); *see also* FED. R. CRIM. P. 32(e).

47. *See* FED. R. CRIM. P. 32(f).

48. *See* 18 U.S.C. § 3664; *see also* FED. R. CRIM. P. 32(i).

in the full amount of each victim's losses . . . without consideration of the economic circumstances of the defendant."[49] This amount of restitution is included in the defendant's Judgment and Commitment order ("J&C") as part of the resolution of the criminal case against the defendant.[50] Often, the sentencing judge makes the defendant's payment of restitution a term of the defendant's post-incarceration supervised release.[51] If the defendant fails to pay his restitution in compliance with the J&C, the defendant's supervised release is revoked, and the defendant is returned to prison.[52] This standard process for determining restitution has far-reaching ramifications for defendants. Under this process, sentencing courts have ordered defendants to pay restitution in amounts far greater than the indictment or the defendant's admissions of guilt could have forecasted.

### *B. The Lack of Honesty in Sentencing*

The MVRA mandates that a judge, not a jury, determine all facts relating to a defendant's restitution, applying a preponderance of the evidence standard.[53] In other words, the MVRA grants judges broad discretion to fashion each restitution order. Due to the broad discretion granted sentencing judges, defendants are routinely ordered to pay restitution well in excess of any amount that a defendant could have reasonably predicted from the charging document.

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49. *See* 18 U.S.C. § 3664(f)(1)(A).

50. *See id.* § 3664(o); *see also id.* § 3556 (explaining that when imposing sentence on a defendant, the court "shall order restitution in accordance with section 3663A, and may order restitution in accordance with section 3663"). Of course, an appeal often is taken from the J&C. On appeal, criminal restitution orders receive varying levels of review depending on the type of appeal. *See* United States v. Wasielak, 139 F. App'x 187, 193 n.10 (11th Cir.) (unpublished decision) ("We review the validity of a restitution order for abuse of discretion." (quoting United States v. Alas, 196 F.3d 1250, 1251 (11th Cir. 1999))), *cert. denied*, 126 S. Ct. 600 (2005); United States v. Wooten, 377 F.3d 1134, 1143 (10th Cir. 2004) (noting that courts review the legality of restitution orders de novo); United States v. Stouffer, 986 F.2d 916, 928 (5th Cir. 1993) (noting that because challenge to restitution was one to "the legality of the award under the Victim and Witness Protection Act of 1982[,]" the review was de novo); United States v. Jackson, 982 F.2d 1279, 1281 (9th Cir. 1992) (noting that the "legality" of a sentence is reviewed de novo but that "an order complying with the statutory framework for ordering restitution is reviewed for an abuse of discretion").

51. After a defendant serves the entire period of incarceration ordered by the sentencing judge, he is often freed from physical confinement on "supervised release," which is essentially a type of probation. While on supervised release, the defendant may have numerous conditions placed on his freedom.

52. *See generally* 18 U.S.C. § 3583 (explaining supervised release after imprisonment); *see also id.* § 3583(d) (authorizing a sentencing court to include as a term of supervised release any discretionary condition of probation in section 3563(b)); *id.* § 3563(b)(2) (providing that the court may require as a condition of a sentence that the defendant make restitution to a victim under title 18, section 3556).

53. *Id.* § 3664(e).

Defendants are sometimes ordered to make restitution to "victims" who were omitted from the indictment and never mentioned during the defendant's change of plea hearing and, occasionally, to persons identified for the first time weeks after the defendant's conviction.[54]

In the pre-*Booker* decision, *United States v. Dickerson*,[55] the Eleventh Circuit approved a restitution order requiring a defendant to pay restitution for conduct that was beyond the statute of limitations period.[56] In the post-*Booker* decision, *United States v. Rand*,[57] the Seventh Circuit approved an order requiring a defendant to pay restitution to victims never mentioned in the indictment and for amounts never reasonably contemplated by the defendant.[58] Both cases exemplify the inequities and the constitutional frailties of the MVRA.

*1.* United States v. Dickerson.—In *Dickerson*, the Eleventh Circuit held that a criminal defendant convicted of fraud must pay restitution to the victim of his fraud in the full amount of the victim's loss, even though the defendant committed part of the crime and, correspondingly, the victim suffered some of the loss, at a time beyond the applicable statute of limitations and years before the defendant was charged or convicted.[59] The Social Security Administration discovered in June 1998, that defendant Dickerson had been receiving disability benefits to which he was not legally entitled.[60] Four years later, in 2002, a federal grand jury indicted Dickerson for wire fraud and Social Security fraud.[61]

Dickerson pled guilty without a plea agreement to all counts of the indictment, including thirty-six counts of wire fraud and one count of Social Security fraud.[62] Although he admitted his fraudulent conduct, Dickerson

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54. It might be argued that the guilty defendant is in the *best* position to know who the victims are and how much loss they suffered. This idea, of course, presumes the guilt of a defendant when everyone is presumed to be innocent until proven guilty by the government beyond a reasonable doubt.

55. 370 F.3d 1330 (11th Cir.), *cert. denied*, 543 U.S. 937 (2004).

56. *Id.* at 1343.

57. 403 F.3d 489 (7th Cir. 2005).

58. *Id.* at 493.

59. *Dickerson*, 370 F.3d at 1342-43. *Dickerson* answered an issue of first impression in the Eleventh Circuit. *See id.* at 1340 n.15. *Dickerson* could have been more narrowly (and more appropriately) decided on the basis urged by the government—that Dickerson's crime was an "ongoing scheme to defraud," that began in 1996 and was continuous. *Id.* at 1336. The Eleventh Circuit's decision was not so narrow. *Id.* at 1342 (holding "that where a defendant is convicted of a crime of which a scheme is an element, the district court must, under 18 U.S.C. § 3663A, order the defendant to pay restitution to all victims for the losses they suffered from the defendant's conduct in the course of the scheme, even where such losses were caused by conduct outside of the statute of limitations").

60. *Id.* at 1332. Dickerson was not eligible for benefits because he was able to work and fully employed. *Id.* Dickerson had started receiving benefits in August 1996 but was continually employed beginning in September 1996. *Id.* at 1332 n.2.

61. *Id.* at 1332-33.

62. *Id.* at 1333-34.

maintained that the sentencing court could not order him to pay restitution for Social Security benefits he received, albeit through fraud, before July of 1997, the date corresponding to the applicable five-year statute of limitations for such crimes.[63] Dickerson contended that "even if he had received those benefits criminally, such conduct was beyond the statute of limitations and therefore not subject to restitution."[64] He argued that he owed restitution only for the "total sum of the benefits he received within the statute of limitations" for which he was indicted and to which he had admitted guilt.[65]

The government conceded that the five-year statute of limitations prevented it from *charging* Dickerson "for wire fraud occurring before July 1997[,]"[66] but nevertheless argued that the defendant was accountable in restitution for his criminal conduct that was more than five years old.[67] The sentencing court agreed with the government and without explanation, ordered Dickerson to pay restitution for periods both inside and outside the five-year time limit.[68] Dickerson appealed.

On appeal, neither party disputed that the MVRA[69] obligated the district court to order restitution for all losses resulting from the wire fraud to which Dickerson had pled guilty.[70] But Dickerson maintained that he could not be required to pay restitution for losses the Social Security Administration had failed for years to uncover and that the government was barred from prosecuting because the conduct was too far in the past.[71]

The defendant rested his arguments against the expanded restitution on the Supreme Court's 1990 decision in *Hughey v. United States*.[72] In *Hughey*, the

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63. *Id.* at 1334. As the court in *Dickerson* noted, the pertinent statute of limitations in 18 U.S.C. § 3282 stated, in pertinent part: "[E]xcept as otherwise expressly provided by law, no person shall be prosecuted, tried, or punished for any offense, not capital, unless the indictment is found or the information is instituted within five years next after such offense shall have been committed." *Dickerson*, 370 F.3d at 1333 n.4 (quoting 18 U.S.C. § 3282).

64. *Dickerson*, 370 F.3d at 1334.

65. *Id.*

66. *Id.* at 1333.

67. *Id.* In fairness to the government, the prosecutor announced during the plea hearing that at sentencing the government would be seeking restitution in the "full amount of the loss incurred by the Social Security Administration" and not just the loss occurring within the statute of limitations period with which the defendant had been charged in the indictment. Brief of Appellee at 3-4, *Dickerson*, 370 F.3d 1330 (No. 02-16559). Often, however, the issue of the amount of restitution is not even broached until after the PSR is prepared.

68. *Dickerson*, 370 F.3d at 1334.

69. *See* 18 U.S.C. § 3663A (2000) (making it mandatory that a court order a defendant to make restitution to the victims of fraud or deceit and for other specified crimes).

70. *Dickerson*, 370 F.3d at 1336.

71. *Id.*

72. 495 U.S. 411 (1990). In *Hughey*, a defendant pled guilty to one count of credit card fraud in exchange for the government's agreement to dismiss three counts of theft and two other counts of credit card fraud. *Id.* at 413-14. The Victim and Witness Protection Act of 1982 ("VWPA"),

issue was whether it was legally appropriate for a sentencing court to order a defendant to make restitution for losses resulting from offenses dismissed as part of a plea bargain.[73] The Supreme Court said it was not proper.[74] The Court then reversed the sentencing court's decision to require the defendant to make restitution for losses beyond those related to the one count of credit card fraud to which the defendant had pled guilty.[75]

Despite the similarities, the Eleventh Circuit refused to apply *Hughey*'s reasoning to the restitution issue it faced in *Dickerson*.[76] The Eleventh Circuit read *Hughey* narrowly to mean that "a criminal defendant cannot be compelled to pay restitution for conduct committed outside of the *scheme*, *conspiracy*, or *pattern* of criminal behavior underlying the offense of conviction."[77] The court concluded, "If a district court may consider relevant conduct occurring outside of the statute of limitations in determining the offense level . . . we fail to see what precludes it from considering such conduct in fashioning a restitution order."[78]

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Pub. L. No. 97-291, 96 Stat. 1248 (1982), was at issue in *Hughey*. The VWPA was a victim restitution provision that preceded the MVRA. After *Hughey*, Congress amended the VWPA to broaden the meaning of "victim." *See* Pub. L. No. 101-647, § 2509, 104 Stat. 4789; 18 U.S.C. § 3663(a)(2) (defining victim of "an offense that involves as an element a scheme, conspiracy, or pattern of criminal activity, [to be] any person directly harmed by the defendant's criminal conduct in the course of the scheme, conspiracy or pattern"). That statutory change has necessarily led courts to liberalize the reach of restitution orders.

73. *See Hughey*, 495 U.S. at 412-13. *Hughey* was indicted for multiple offenses but was convicted of only one. *Id.* at 413-14.

74. *Id.* at 413.

75. *Id.* at 422.

76. The *Hughey* decision rested on the Court's statutory construction of the VWPA; it did not rest on constitutional grounds. *Hughey* also dealt with the VWPA, not the MVRA. Therefore, *Hughey* unquestionably did not bind the Eleventh Circuit.

77. United States v. Dickerson, 370 F.3d 1330, 1341 (11th Cir.), *cert. denied*, 543 U.S. 937 (2004) (emphasis added).

78. *Id.* at 1342. The court in *Dickerson* was correct that before *Blakely* and *Booker*, courts routinely considered conduct outside the indictment, conduct for which the defendant had been acquitted, and even time-barred conduct, in rendering sentences. *See, e.g.*, United States v. Lawrence, 189 F.3d 838, 844 (9th Cir. 1999) (approving the sentencing court's reliance on conduct for which a defendant was not convicted, reasoning that such "sentencing does not result in punishment for any offense other than the one of which the defendant was convicted[;] [r]ather, the defendant is punished . . . for the fact that the present offense was carried out in a manner which warrants increased punishment"); United States v. Welsand, 23 F.3d 205, 207 (8th Cir. 1994) (holding that when a defendant is convicted of a "scheme" which thrives over years, a sentencing court can order the defendant to pay restitution for periods outside the statute of limitations); United States v. Pierce, 17 F.3d 146, 150 (6th Cir. 1994) (holding that "conduct that cannot be prosecuted under the applicable statute of limitations can be used to determine relevant conduct" for sentencing); United States v. Wishnefsky, 7 F.3d 254, 256-57 (D.C. Cir. 1993) (approving of a district court's consideration of conduct occurring beyond the statute of limitations for which a

*Dickerson* reveals that pursuant to the MVRA, even time-barred conduct, which the government is legally prohibited from presenting to a jury, may be injected into the case at sentencing when the judge is the sole decision-maker.

2. United States v. Rand.—The Seventh Circuit's decision in *United States v. Rand* also illustrates the surprise that defendants sometimes face as a result of post-conviction, judge-determined decisions regarding restitution. In *Rand*, the defendant pled guilty to one count of conspiracy in violation of 18 U.S.C. § 371.[79] "[H]e specifically admitted to several acts of fraud involving the identity information of five individual victims."[80] The defendant had been indicted in a seven-count indictment but pled guilty to only Count One in exchange for the government's agreement to dismiss the remaining six counts.[81] Rand admitted participating in a fraud scheme with his co-conspirators to steal personal information from employees of a Gary, Indiana public school system.[82] Count One specifically listed four street addresses used in the scheme and "described the general nature of the conspiracy" this way:

> It was part of the conspiracy that the defendants: (1) obtained the names and social security numbers of employees of the Gary Community School Corporation, Gary, Indiana, in order to establish credit in the employees' names without their knowledge, authority and permission . . . [and] (2) obtained credit cards in the employees' names in order to purchase merchandise for the defendants' own personal

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defendant was not charged); United States v. August, 984 F.2d 705, 713 (6th Cir. 1992) (noting that conduct that comprises an offense for which a defendant has been acquitted may be used at sentencing as a basis to enhance a sentence). *But see* United States v. Silkowski, 32 F.3d 682, 684, 690 (2d Cir. 1994) (remanding the issue of restitution in a case of theft of public funds (in violation of 18 U.S.C. § 641), noting that the case did not involve a plea to a "continuing offense" and holding that the offense of conviction was "circumscribed by the five year statute of limitations" such that "conduct committed within the offense of conviction is only that conduct going back five years from the date of the information and waiver of indictment"); United States v. Streebing, 987 F.2d 368, 376 (6th Cir. 1993) (limiting restitution to the loss caused by the mailing that constituted the mail fraud for which the defendant was convicted and denying restitution for other acts committed in the scheme, which were not in furtherance of the mail fraud for which the defendant was convicted).

79. *See* United States v. Rand, 403 F.3d 489, 491 (7th Cir. 2005). Section 371 states in pertinent part:

> If two or more persons conspire either to commit any offense against the United States, or to defraud the United States, or any agency thereof in any manner or for any purpose, and one or more of such persons do any act to effect the object of the conspiracy, each shall be fined under this title or imprisoned not more than five years, or both.

*See* 18 U.S.C.A. § 371 (West 2005).

80. *See Rand*, 403 F.3d at 492.

81. *Id.* at 491-92.

82. *Id.* at 491.

purposes and benefit.[83]

After Rand's plea of guilty was accepted by the district court, a pre-sentence investigation was conducted and a report prepared.[84] The PSR indicated that the conspiracy involved not four, but nine different street addresses; that Rand had committed twenty-five incidents of identity theft not mentioned in the indictment; and that based on these additional factual findings, Rand was responsible to his victims for $90,744.30 in restitution.[85] Rand objected to the PSR, arguing that he was responsible "only for the specific fraudulent acts he affirmatively admitted in his guilty plea, which gave rise to losses totaling just $12,594.90."[86] The sentencing court rejected both the findings in the PSR and the defendant's argument.[87] The court decided that Rand owed $57,431.67, covering "losses resulting from acts of fraud explicitly listed in the . . . indictment," plus $7241.76 in losses, which were not.[88]

Rand appealed, asserting that the restitution order "was impermissible since it included damages relating to individual identity theft victims whom Rand did not affirmatively identify in his guilty plea, who were not identified specifically in the original indictment or who were not employees of the Gary, Indiana public school system."[89] The Seventh Circuit rejected the defendant's challenge and affirmed the order of the district court.[90] The court acknowledged that conduct underlying restitution must be articulated in the indictment or plea agreement, but said that "specific victims need not be."[91] The court reasoned further, "[A]ny individual 'directly harmed' by Rand's 'criminal conduct in the course of the [fraud] scheme, conspiracy, or pattern' is *presumptively* included in the restitution calculus."[92] The Seventh Circuit concluded:

> Rand's attempts to limit the scope of his liability by listing in his plea agreement acts relating to only a few individual victims is thus unavailing. Rand may not evade the clear import of the MVRA and leave his victims in the proverbial lurch simply by artful pleading. Having pleaded guilty to conspiracy, he may not then pick and choose the victims for which he will be held responsible.[93]

In short, the Seventh Circuit was content to allow the sentencing court to make

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83. *Id.* at 492.
84. *Id.*
85. *Id.*
86. *Id.*
87. *Id.*
88. *Id.*
89. *Id.* at 493.
90. *Id.* at 495-96.
91. *Id.* at 494.
92. *Id.* at 495 (emphasis added) (second bracket in original) (quoting 18 U.S.C. § 3663A(a)(2) (2000)).
93. *Id.*

findings of fact about the identity of the defendant's victims and the amount of the victims' losses, even though the defendant could not have predicted such findings from the indictment or from the facts he admitted during his plea hearing.

*Dickerson* and *Rand* are just two samples of the hazards of restitution that plague defendants at the "back end" or sentencing phase of the trial-level criminal process.[94] In effect, the MVRA allows federal district court judges broad discretion to determine restitution in an amount totally unexpected by a defendant, in a manner that circumvents any bargain reached by a defendant during plea negotiations, and even in an amount that undermines a statute of limitations, which would otherwise totally bar prosecution of a crime. Arguably, neither judge nor jury should weigh time-barred conduct or make findings extraneous to the facts charged in an indictment or admitted by a defendant during a plea. At a minimum, a defendant should have the protection of a jury of his peers as guaranteed by the Sixth Amendment to weigh these issues, not a judge, a single person armed with information neither proved beyond a reasonable doubt nor admitted by the defendant.

*3. The Restitution Process Defies Rule 11 of the Federal Rules of Criminal Procedure.*—"Rule 11 expressly directs the district judge to inquire whether a defendant who pleads guilty understands the nature of the charge against him and whether he is aware of the consequences of his plea."[95] More specifically, Rule 11(b)(1)(K) mandates that the district court "inform the defendant of, and determine that the defendant understands," certain rights, including "the court's authority to order restitution."[96] It is the contention of this Article that Rule 11

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94. *See also* United States v. Benjamin, 125 F. App'x 438, 442 (3d Cir. 2005) (unpublished) (holding that the district court did not abuse its discretion when ordering defendant to make restitution for computers he obtained and sold as part of a fraud scheme even though the computers were not charged in the indictment); United States v. Wasielak, 139 F. App'x 187, 190, 194 (11th Cir.) (unpublished) (rejecting argument that sentencing court erred in ordering the defendant to pay restitution for twenty-five stolen all-terrain vehicles, although indictment identified only twelve vehicles and the defendant did not admit involvement with those additional vehicles), *cert. denied*, 126 S. Ct. 600 (2005); United States v. Coffee, 110 Fed. App'x 654, 656 (6th Cir. 2004) (unpublished) (rejecting defendant's argument that restitution was improper even though determined after the defendant's plea, noting that "[r]estitution is not confined to harm caused by the particular offense of conviction[]" in a fraud scheme), *cert. denied*, 125 S. Ct. 978 (2005); United States v. Portillo, 363 F.3d 1161, 1165 n.2 (11th Cir.) (rejecting the defendant's argument that names of victims had to appear in indictment before they could be awarded restitution and noting that four of the victims were specifically named in the pre-sentence report), *cert. denied*, 125 S. Ct. 448 (2004); United States v. Henoud, 81 F.3d 484, 489 (4th Cir. 1996) (noting that restitution is "not necessarily fixed by the description given in the corresponding charge itself" and affirming an award that reflected the jury's implicit finding of a scheme to defraud); United States v. Jackson, 982 F.2d 1279, 1282-83 (9th Cir. 1992) (affirming an order of restitution made pursuant to the VWPA for an amount not charged in the count of indictment to which the defendant pled guilty).

95. *See* McCarthy v. United States, 394 U.S. 459, 464 (1969).

96. *See* FED. R. CRIM. P. 11(b)(1)(K); *see also* United States v. Showerman, 68 F.3d 1524,

is breached in cases like *Dickerson* and *Rand*[97] when a court fails to advise a defendant in a real and practical way during the plea hearing of the maximum amount of restitution the defendant faces at sentencing. The federal courts of appeal seem to agree that Rule 11 is breached when a sentencing court fails altogether to advise a defendant about the possibility of restitution, but they are split on whether such an omission that defies Rule 11 should have any real consequences. Most circuits find that when a district court violates Rule 11 by failing to mention restitution at the change of plea hearing, the omission is merely a harmless error.[98] Furthermore, not one court appears to deem it a violation of Rule 11 when a defendant pleads guilty expecting one maximum amount of restitution only to find that amount burgeon at sentencing when the court takes into account other conduct and other victims uncovered by the pre-sentence investigation. Nevertheless, it is fiction to say that in such instances a defendant pleads guilty with any true comprehension of the consequences of that plea on the amount of restitution he will be expected to pay. Thus, at a minimum, the MVRA-mandated process often causes a violation of the spirit and purpose of Rule 11. Such violations are particularly troubling considering that once a plea is accepted by the district court judge, it can rarely be withdrawn.[99]

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1527 (2d Cir. 1995) ("[A]t bottom, the colloquy required by Rule 11 is meant to ensure that the defendant is aware of the consequences of his plea." (alteration in original and citation omitted)).

97. *See* discussion *supra* Part II.B.1-2.

98. *See, e.g.*, United States v. Glinsey, 209 F.3d 386, 394-95 (5th Cir. 2000) (explaining that Rule 11 requires a district court to "inform the defendant . . . , when applicable, that the court may also order the defendant to make restitution to any victim of the offense," but refusing to allow a defendant to withdraw his plea, even though neither the plea agreement nor change of plea colloquy mentioned restitution; finding that reducing the restitution to the maximum amount of available fine protected defendant's substantial rights (quoting FED. R. CRIM. P. 11(c)(1))); United States v. Gonzalez, 202 F.3d 20, 28 (1st Cir. 2000) (noting that even when a defendant is not warned of the potential for restitution, the arguable error is harmless if restitution is less than a possible fine of which the defendant was warned); United States v. Russo, No. 98-3245, 2000 WL 14298, at *3-4 (10th Cir. Jan. 10, 2000) (unpublished) (applying a harmless error review to a defendant's Rule 11 challenge based on the district court's failure to advise on restitution); United States v. Morrison, No. 95-1459, 1997 WL 636623, at *2-3 (6th Cir. Oct. 10, 1997) (unpublished) (noting that Rule 11 required district court to advise a defendant, "when applicable, that the court may also order restitution to any victim of the offense[,]" but finding that the trial judge's omission was "harmless" error); United States v. McCarty, 99 F.3d 383, 386-87 (11th Cir. 1996) (acknowledging that failure of district court to discuss restitution at plea colloquy violated Rule 11, but applying harmless error analysis to find that it did not mean that defendant should be able to withdraw plea); United States v. Fox, 941 F.2d 480, 484-85 (7th Cir. 1991) (holding that it is harmless error when district court fails to apprise defendant of restitution but informs defendant of possible fine in excess of amount of restitution ultimately ordered). *But see* United States v. Showerman, 68 F.3d 1524, 1528 (2d Cir. 1995) (holding that Rule 11 was violated in a case where plea agreement mentioned possibility of restitution, but that failure to mention possibility of restitution at a plea hearing was not a harmless error).

99. Generally, once a defendant enters a plea of guilty, he or she may not withdraw that plea

## III. *BOOKER*'S PRINCIPLES EXTEND TO THE MVRA

Although the decision in *Booker* did not address the Mandatory Victims Restitution Act, Part One of the majority's decision, coupled with the Supreme Court's reasoning from its earlier decisions in *Apprendi v. New Jersey*[100] and *Blakely v. Washington*,[101] strongly suggests that the MVRA violates the Sixth[102] Amendment.[103]

### *A. Restitution—Element or Sentencing Factor?*

All members of the Supreme Court agree that the government "must charge in the indictment and prove at trial beyond a reasonable doubt the actual elements of [a criminal] offense."[104] What constitutes an "element," however, is less clear. Historically, the Court distinguished between "elements" that must be presented

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based on a subsequent change of heart. *See* FED. R. CRIM. P. 11(c)(3)(B) (explaining "that the defendant has no right to withdraw the plea if the court does not follow the recommendation or request[]" of the defendant, even when unopposed by the government); *see also* United States v. Davis, 410 F.3d 1122, 1125 (9th Cir.) (noting that "[a]fter a defendant is sentenced . . . a plea may be set aside only on direct appeal or collateral attack[]" (internal citation and quotation omitted)), *amended and superseded by* 428 F.3d 802 (9th Cir. 2005); United States v. George, 403 F.3d 470, 472 (7th Cir.) (noting that "[a]ctual innocence might supply a 'fair and just reason' [sufficient] to withdraw a guilty plea" before sentencing (citation omitted)), *cert. denied*, 126 S. Ct. 636 (2005).

100. 530 U.S. 466 (2000).

101. 542 U.S. 296 (2004).

102. The Supreme Court has not decided whether or not the government violates a defendant's Fifth Amendment right to presentment by failing to include sentencing enhancements in the indictment. *See Apprendi*, 530 U.S. at 477 n.3. Therefore, this Article does not directly address whether or not restitution must be presented to a grand jury and/or charged in an indictment to comply with the Fifth Amendment. The Article does urge inclusion of restitution in the charging document, nevertheless.

103. Part Two of *Booker*, in which the Court constructed a "remedy" for the portions of the Guidelines the Court thought made the Guidelines as a whole invalid, does not help predict whether the Court would find that the MVRA violates the Sixth Amendment because Part Two of *Booker* deals only with remedying the invalid portions of the Guidelines. The wording and structure of the Guidelines share little in common with the language, purpose, and structure of the MVRA. Therefore, Part Two of the *Booker* decision will only be addressed in this Article to the extent that it provides some insight into how the Supreme Court might remedy the constitutional infirmity in the MVRA.

104. *Apprendi*, 530 U.S. at 527 (O'Connor, J., dissenting); *see also In re* Winship, 397 U.S. 358, 361 (1970).

to a jury,[105] and a mere "sentencing consideration" that need not be.[106] Where the line falls between an element and a sentencing consideration is anything but obvious. Even the legislature's "characterization of a fact or circumstance as an 'element' or a 'sentencing factor' is not determinative of the question."[107]

Starting with *Apprendi*, a majority of the Supreme Court adopted a legal rule for sentencing that appears to equate an "element" of an offense with any factor that may increase a defendant's *punishment* beyond what the defendant's own admissions or the jury's verdict would predict.[108] In *Apprendi*, the Court said that the inquiry is not an inquiry of form, "but of effect—does the required finding expose the defendant to a greater punishment than that authorized by the jury's guilty verdict?"[109] The Court also announced the following rule: "Other than the fact of a prior conviction, any fact that increases the penalty for a crime beyond the prescribed statutory maximum must be submitted to a jury, and proved beyond a reasonable doubt."[110]

In *Blakely* and again in the first part of *Booker*, the Supreme Court re-

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105. *See Apprendi*, 530 U.S. at 477 (finding that a criminal defendant is entitled to "a jury determination that [he] is guilty of every element of the crime with which he is charged, beyond a reasonable doubt" (brackets in original) (quoting United States v. Gaudin, 515 U.S. 506, 510 (1995))).

106. *See* McMillan v. Pennsylvania, 477 U.S. 79, 93 (1986). As the majority in *Apprendi* noted, in the years surrounding the Nation's founding, the "distinction between an 'element' . . . and a 'sentencing factor' was unknown." *See Apprendi*, 530 U.S. at 478. Indictments generally contained all the facts and circumstances of a defendant's crime such that the defendant could tell what judgment would result if he were convicted. *Id.* In other words, "the substantive criminal law tended to be sanction-specific." *Id.* at 479. "The judge was meant simply to impose that sentence" prescribed for the offense charged and proven. *Id.* Therefore, the evaluation of what did and did not constitute an element was inconsequential. Before *Apprendi*, in *McMillan*, the Supreme Court distinguished between "elements" of a crime and "sentencing factors," suggesting that while a jury must determine all elements, determination of sentencing factors would be left to the discretion of the sentencing judge. *See McMillan*, 477 U.S. at 86, 93. According to the Court in *Apprendi*, the majority in *McMillan* created a "constitutionally novel and elusive distinction between 'elements' and 'sentencing factors.'" *Apprendi*, 530 U.S. at 494.

107. *See* United States v. Booker, 543 U.S. 220, 231 (2005) (quoting Ring v. Arizona, 536 U.S. 584, 605 (2002)); *see also Ring*, 536 U.S. at 602 ("If a State makes an increase in a defendant's authorized punishment contingent on the finding of a fact, that fact—no matter how the State labels it—must be found by a jury beyond a reasonable doubt.").

108. *See Apprendi*, 530 U.S. at 527 (O'Connor, J., dissenting) (emphasis added) (acknowledging that the government must charge in the indictment and prove at trial beyond a reasonable doubt all elements of an offense, but noting that the issue in *Apprendi* "concerns the distinct question of when a fact that bears on a defendant's punishment, but which the legislature has not classified as an element of the charged offense, must nevertheless be treated as an offense element").

109. *Id.* at 494 (majority opinion).

110. *Id.* at 490. Throughout this Article, the rule will generally be called the "rule in *Apprendi*."

affirmed the rule announced in *Apprendi*.[111] In fact, the *Blakely* decision refined or, more accurately, expanded the rule in *Apprendi* by rejecting the notion that the statutory maximum for purposes of the Sixth Amendment is the maximum penalty in the statute containing the substantive crime charged.[112] In *Blakely*, the government argued that the sentencing court had not violated the rule in *Apprendi* because the court sentenced the defendant to fifty-three months of incarceration, which was less than the statutory maximum for a class B felony, the type of felony committed by the defendant.[113] The Supreme Court rejected that argument, declaring that "the 'statutory maximum' for *Apprendi* purposes is the maximum sentence a judge may impose *solely on the basis of the facts reflected in the jury verdict or admitted by the defendant*."[114]

If the rule in *Apprendi* applies to the MVRA, then the MVRA violates the Sixth Amendment because the MVRA requires a sentencing judge to impose restitution based on the judge's own factual findings, not on facts reflected solely in a jury verdict or admitted by a defendant. In turn, the rule applies to the MVRA if restitution constitutes an element of an offense or is part of a defendant's "punishment" for an offense. As emphasized in *Booker*, "[I]f [the government] makes an increase in a defendant's authorized punishment contingent on the finding of a fact, that fact—no matter how the State labels it—must be found . . . beyond a reasonable doubt."[115] "When a judge inflicts punishment that the jury's verdict alone does not allow, the jury has not found all the facts 'which the law makes essential to the punishment,' . . . and the judge exceeds his proper authority."[116] In short, if restitution is punishment, under the reasoning of *Apprendi*, *Blakely*, and *Booker*, a defendant is entitled to have a jury decide it by the heightened standard of proof guaranteed by the Sixth Amendment.

### *B. Restitution Is Criminal Punishment*

*1. The Supreme Court Has Not Decided, but the MVRA Says "Penalty."*— The Supreme Court has never specifically decided if restitution is part of a defendant's criminal "punishment,"[117] but the MVRA suggests that it is.[118] The

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111. Blakely v. Washington, 542 U.S. 296, 303-04 (2004); *see Booker*, 543 U.S. at 244 ("reaffirm[ing]" the rule announced in *Apprendi*).

112. *See Blakely*, 542 U.S. at 302-05.

113. *Id.* at 303.

114. *Id.*

115. *Booker*, 543 U.S. at 231 (quoting Ring v. Arizona, 536 U.S. 584, 602 (2002)).

116. *Blakely*, 542 U.S. at 304 (internal citation omitted).

117. The Supreme Court has, in a Chapter 7 bankruptcy context, associated restitution with punishment. *See* Kelly v. Robinson, 479 U.S. 36, 52 (1986); discussion *infra* notes 123-26; *see also* Jones v. United States, 526 U.S. 227, 235 (1999) (finding in the context of reviewing the federal carjacking statute that serious bodily harm to a victim is an "element" of the crime of carjacking).

118. For a recent and more thorough discussion of the punitive and non-punitive nature of restitution, see Brian Kleinhaus, Note, *Serving Two Masters: Evaluating the Criminal or Civil*

MVRA, which governs restitution, is codified in 18 U.S.C. §§ 3663-3664.[119] Section 3663 addresses restitution generally,[120] and section 3663A mandates restitution for specified offenses.[121] In both sections, Congress used the word "penalty" to refer to restitution that may, in some cases, and must, in others, be imposed upon a defendant when her crime directly and proximately causes a victim to suffer a monetary loss. Section 3663 and Section 3663A say that restitution is available "in addition to . . . any other penalty authorized by law."[122] The obvious implication of Congress's word choice is that restitution is punishment to be included in a defendant's sentence and accompanying J&C, along with incarceration, a fine, and other penalties that the law allows.[123]

Although the Supreme Court has not decided if restitution is punishment, the conclusion that restitution is a penalty or "punishment" is consistent with the Supreme Court's description of restitution in another context. In *Kelly v. Robinson*,[124] the Supreme Court held that a bankruptcy debtor cannot discharge her criminal restitution obligations in Chapter 7 bankruptcy proceedings, explaining:

> Restitution is an effective rehabilitative penalty because it forces the defendant to confront, in concrete terms, the harm his actions have caused. Such a penalty will affect the defendant differently than a traditional fine, paid to the State as an abstract and impersonal entity, and often calculated without regard to the harm the defendant has caused.

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*Nature of the VWPA and MVRA Through the Lens of the Ex Post Facto Clause, the Abatement Doctrine, and the Sixth Amendment*, 73 FORDHAM L. REV. 2711 (2005).

119. The Federal Guidelines also contain a provision addressing restitution, but the Guidelines refer back to 18 U.S.C. §§ 3663-3664 (2000). *See* USSG, *supra* note 6, § 5E1.1.

120. Section 3663 provides that when sentencing a defendant, a court *may* order restitution. *See* 18 U.S.C. § 3663(a)(1)(A) ("The court, when sentencing a defendant convicted of an offense under this title . . . other than an offense described in section 3663A(c), may order, in addition to . . . any other penalty authorized by law, that the defendant make restitution to any victim of such offense . . . .").

121. 18 U.S.C. § 3663(a)(1).

122. *See id.* § 3663A(a)(1)(A) ("The court, when sentencing a defendant convicted of an offense under this title . . . other than an offense described in section 3663A(c), may order, in addition to . . . any other penalty authorized by law, that the defendant make restitution to any victim of such offense . . . ."); *see also id.* § 3663A(a)(1) ("Notwithstanding any other provision of law, when sentencing a defendant convicted of an offense described in subsection (c), the court shall order, in addition to . . . any other penalty authorized by law, that the defendant make restitution to the victim of the offense.").

123. Typically, the starting point for construing a statutory provision is to examine the language of the statute. *See* Kelly v. Robinson, 479 U.S. 36, 43-44 (1986). *But see* United States v. Newman, 144 F.3d 531, 540 (7th Cir. 1998) (rejecting the idea that the VWPA or the MVRA is punitive in nature just because those statutes use the term "penalty" and concluding that neither "expressly characterizes restitution as a criminal or civil penalty").

124. 479 U.S. 36 (1986).

> Similarly, the direct relation between the harm and the punishment gives restitution a more precise deterrent effect than a traditional fine.[125]

*2. The Appellate Courts Are Split.*—"Whether restitution is criminal punishment . . . [is] by no means [a] settled question[] in [lower federal] courts across the country."[126] A majority of the federal courts of appeals, including the First, Second, Third, Fourth, Fifth, Sixth, Ninth, and Eleventh Circuits, have held that restitution is punishment.[127] Two circuits, the Seventh and Tenth, have

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125. *Id.* at 49 n.10 (citing Note, *Victim Restitution in the Criminal Process: A Procedural Analysis*, 97 HARV. L. REV. 931, 937 (1984)). *Kelly* contains additional language suggesting that restitution is punishment, *see* 479 U.S. at 52; however, the state restitution provision at the heart of that case was different than the provisions in the MVRA. *Id.* at 52-53. The Connecticut restitution statute at issue "provide[d] for a flexible remedy tailored to the defendant's situation." *Id.* at 53. The Connecticut statute did not mandate restitution like the MVRA. Thus, *Kelly* is, at best, a limited predictor of how the Supreme Court would view restitution under the MVRA. Nevertheless, even Justice Marshall's dissent in *Kelly* seemed to acknowledge that restitution constitutes punishment of the defendant. *See id.* at 55 (Marshall, J., dissenting) (remarking that "[r]estitution is not simply a punishment that incidentally compensates the victim" and that "compensation is an essential element of a restitution scheme"). The Supreme Court's ruling in *Hughey v. United States*, 495 U.S. 411 (1990), is also consistent with the idea that restitution is punishment. There, the Court held that it was improper under an earlier restitution statute for a sentencing court to order a defendant to pay restitution for offenses that were dismissed as part of a plea bargain. *Id.* at 422. The Supreme Court expressed concern about ensuring that the amount of restitution is confined to the loss caused by the conduct underlying the offense of conviction. *Id.* at 416. If the focus of restitution was solely compensation and not punishment, then the Court should have been less concerned with defining the limits of restitution in a way that restricted it to the proximate results of the criminal conduct and more concerned with reimbursing victims.

126. United States v. Garcia-Castillo, 127 F. App'x 385, 391 n.4 (10th Cir.) (unpublished), *cert. denied*, 125 S. Ct. 2951 (2005).

127. *See* United States v. Adams, 363 F.3d 363, 365 (5th Cir. 2004) (noting that "restitution under the MVRA is . . . criminal [punishment]"); United States v. Ross, 279 F.3d 600, 609 (8th Cir. 2002) ("[R]estitution is a criminal 'penalty.'" (quoting United States v. Williams, 128 F.3d 1239, 1240 (8th Cir. 1997))); United States v. Syme, 276 F.3d 131, 159 (3d Cir. 2002) ("We consider restitution orders made pursuant to criminal convictions to be criminal penalties."); United States v. Schulte, 264 F.3d 656, 662 (6th Cir. 2001) ("[R]estitution imposed under the VWPA is punishment for the purpose of the Ex Post Facto Clause[;] . . . [w]e see no reason why we should not find that this is also true under the MVRA."); United States v. Rostoff, 164 F.3d 63, 71 (1st Cir. 1999) ("The nature of restitution is penal and not compensatory."); United States v. Bruchey, 810 F.2d 456, 461 (4th Cir. 1987) (finding that criminal restitution is "fundamentally 'penal' in nature"); United States v. Brown, 744 F.2d 905, 909 (2d Cir. 1984) ("Restitution undoubtedly serves traditional purposes of punishment."); *see also* United States v. Siegel, 153 F.3d 1256, 1259 (11th Cir. 1998) (finding that restitution under the MVRA is a penalty); United States v. Williams, 128 F.3d 1239, 1241 (8th Cir. 1997) (finding in the context of a criminal defendant's Ex Post Facto Clause challenge that the wording of the MVRA compelled a holding that restitution is punishment); United States v. Keith, 754 F.2d 1388, 1392 (9th Cir. 1985) (finding that when

decided to the contrary.[128] The Eighth Circuit has, in a move of utter inconsistency, held that restitution under the MVRA is punishment for purposes of the ex post facto clause of the Constitution but is not punishment for purposes of *Booker*.[129]

Whether expressly or implicitly, the circuits that recognize restitution as punishment acknowledge the punitive impact of restitution on a defendant. A defendant cannot escape an order of restitution by entering into a contract with victims in which the victims absolve the defendant from liability;[130] the imposition of restitution does not bar a subsequent civil action by a victim against a defendant;[131] and a defendant may be ordered to pay restitution even if all the proceeds of his crime have been forfeited to the government.[132] In addition, under the Federal Sentencing Guidelines, the amount of the victims' losses for purposes

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Congress enacted the Victim and Witness Protection Act of 1982, it "made restitution under the Act a criminal penalty"). Several of the circuit courts that have ruled that restitution is punishment did so long before *Booker*, on the way to deciding that the Seventh Amendment does not give a defendant a jury trial on the issue of restitution. *See, e.g.*, *Brown*, 744 F.2d at 909 (finding that because restitution is a matter of punishment, a defendant is not entitled to the requirements of a civil adjudication); *see also Keith*, 754 F.2d at 1392 (same).

128. *See Garcia-Castillo*, 127 F. App'x at 390 ("Restitution ordered under the VWPA and MVRA . . . is not criminal punishment."); United States v. George, 403 F.3d 470, 473 (7th Cir.) (finding that restitution "is not a criminal punishment but instead is a civil remedy administered for convenience by courts that have entered criminal convictions"), *cert. denied*, 126 S. Ct. 636 (2005). As pointed out in Kleinhaus, *supra* note 118, at 2752, the Seventh Circuit viewed "restitution as a civil remedy in the context of the Ex Post Facto Clause . . . and as a criminal remedy in the context of a Seventh Amendment challenge."

129. *See* United States v. Agboola, 417 F.3d 860, 870 (8th Cir. 2005) (stating without analysis that "restitution is essentially a civil remedy included with a criminal judgment" so that *Booker* does not apply (internal quotation marks omitted) (quoting United States v. Rand, 403 F.3d 489, 495 n.3 (7th Cir. 2005))); United States v. Reichow, 416 F.3d 802, 807 (8th Cir.) (distinguishing United States v. Williams, 128 F.3d 1239, 1241 (8th Cir. 1997), in which the Eighth Circuit held that a restitution order under the MVRA is a criminal penalty for purposes of an ex post facto violation), *cert. denied*, 126 S. Ct. 784 (2005). *But see* United States v. Ross, 279 F.3d 600, 609-10 (8th Cir. 2002) (noting that restitution is punishment but avoiding a decision on whether the *Apprendi* rule applied to orders of restitution).

130. *See* United States v. Twitty, 107 F.3d 1482, 1493 n.12 (11th Cir. 1997); *see also* United States v. Bearden, 274 F.3d 1031, 1041 (6th Cir. 2001) (noting that "a private settlement between a criminal wrongdoer and his victim . . . does not preclude a district court from imposing a restitution order for the same underlying wrong").

131. *Keith*, 754 F.2d at 1391. Restitution also "tracks 'the recovery to which [the victim] would have been entitled in a civil suit against the criminal.'" United States v. Behrman, 235 F.3d 1049, 1052 (7th Cir. 2000) (alteration in original) (quoting United States v. Martin, 195 F.3d 961, 968 (7th Cir. 1999)). Of course, in such a civil suit, the defendant would be entitled to a jury determination. *See generally* Kirgis, *supra* note 15 (discussing how civil litigants are now provided more protection under the Seventh Amendment than criminal defendants are under the Sixth).

132. *See, e.g.*, United States v. Leon-Delfis, 203 F.3d 103, 115-116 (1st Cir. 2000).

of restitution is often the same amount of "loss" on which the defendant's incarceration is based.[133] A defendant is obligated to pay interest on restitution[134] and an additional penalty if the restitution becomes delinquent.[135] The United States may collect restitution by imposing a lien on the defendant's property, garnishing a defendant's wages, executing a lien on her vehicles, or by any other means that may be used to enforce a judgment under federal or state law.[136] Most compelling, however, is the fact that when a defendant fails to pay restitution ordered by her judgment and commitment order, the failure can result in additional prison time.[137] Whether or not restitution serves a penal function or a dual punishment and compensation role, its effect from the defendant's viewpoint is certainly penal. As the Eleventh Circuit has recognized, restitution is a "criminal penalty meant to have strong deterrent and rehabilitative effect."[138] And according to the Second Circuit, restitution is not a civil remedy

> simply because it also achieves some of the purposes of a civil judgment. Restitution undoubtedly serves traditional purposes of punishment. The prospect of having to make restitution adds to the deterrent effect of imprisonment and fines, penalties that might seem to some offenders less likely to be imposed than restitution. Restoring the victim's property also serves the legitimate penal purpose of vindicating society's interest in peaceful retribution. Finally, restitution can be a useful step toward

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133. *See, e.g.*, United States v. Rana, 129 F. App'x 890, 894 (5th Cir.) (vacating and remanding case after *Booker* "because the district court, and not the jury, determined the amount of restitution and loss, which was then used to calculate [the defendant]'s sentence"), *cert. denied*, 126 S. Ct. 390 (2005); *see also* United States v. McDaniel, 398 F.3d 540, 548 (6th Cir. 2005) (finding that the defendants' Sixth Amendment rights were violated "because the district court relied on judge-found facts to impose a [four-point] sentencing enhancement" for loss amount, after determining that loss was more than $10,000 but less than $30,000). *But see* United States v. Antonakopoulos, 399 F.3d 68, 83 (1st Cir. 2005) (distinguishing an order of restitution as "a separate calculation from the calculation of loss"). The problem is not how the losses are calculated but that the result is often the same.

134. *See* 18 U.S.C. § 3612(f) (2000).

135. *See id.* § 3612(g).

136. *See id.* § 3613(a).

137. *See id.* §§ 3583, 3613A(a)(1), 3614(a) (noting that "if a defendant knowingly fails to pay . . . restitution[,]" the defendant may be re-sentenced to any sentence which might originally have been imposed); *see also* USSG, *supra* note 6, Chapter 7, Pt. A(2)(b) (explaining that supervised release is a "form of post-imprisonment supervision created by the Sentencing Reform Act . . . [and] imposed by the court as a part of the sentence of imprisonment at the time of initial sentencing"). Supervised release may be revoked and a defendant returned to incarceration. *Id.*; *see also id.* § 7B1.1 (classifying supervised release violations); *id.* § 7B1.3 (explaining that some violations require a court to revoke supervised release and others allow it).

138. *See* United States v. Twitty, 107 F.3d 1482, 1493 n.12 (11th Cir. 1997) (internal quotation marks omitted) (quoting United States v. Hairston, 888 F.3d 1349, 1355 (11th Cir. 1989)).

rehabilitation.[139]

Those circuits that hold that restitution is not punishment have essentially concluded that the MVRA (and/or its predecessor, the VWPA) is not punitive but, rather, designed only "to ensure that victims . . . are made whole for their losses."[140] For example, the Seventh Circuit declared:

> Restitution has traditionally been viewed as an equitable device for restoring victims to the position they had occupied prior to a wrongdoer's actions. It is separate and distinct from any punishment visited upon the wrongdoer and operates to ensure that a wrongdoer does not procure any benefit through his conduct at others' expense.[141]

These courts have also focused on the administrative ease with which restitution can be tacked onto a judgment and commitment order, calling it "a civil remedy administered for convenience by courts."[142]

The conclusion of the minority not only contradicts the rule in most circuits, but also ignores the plain language of the MVRA and the common-sense, practical impact of restitution on defendants. The minority focuses on the victim-aspect of restitution, ignoring the defendant-aspects.[143] As one district court judge recently noted when analyzing whether a defendant is entitled to have a jury find the amount of restitution beyond a reasonable doubt, "[I]ndeed, there is an element of sophistry in stating that something imposed as part of a sentence in a criminal case is in fact not punishment for the crime."[144] This sentiment is particularly true when one considers that if the court finds by a preponderance of the evidence that a defendant has failed to pay restitution imposed as a condition of supervised release, the court can revoke a defendant's liberty and return the defendant to prison.[145]

While conceding that the issue is far from resolved, this Article presumes that restitution is part of a defendant's criminal punishment. The rest of this Article

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139. *See* United States v. Brown, 744 F.2d 905, 909 (2d Cir. 1984).

140. United States v. Garcia-Castillo, 127 F. App'x 385, 390 (10th Cir.) (quoting United States v. Nichols, 169 F.3d 1255, 1279 (10th Cir. 1999)), *cert. denied*, 125 S. Ct. 2951 (2005); *see also* United States v. George, 403 F.3d 470, 473 (7th Cir.) (finding that restitution "is not a criminal punishment but instead a civil remedy administered for convenience by courts that have entered criminal convictions"), *cert. denied*, 126 S. Ct. 636 (2005); United States v. Rand, 403 F.3d 489, 495 n.3 (7th Cir. 2005) (finding that because "restitution is essentially '[a] civil remedy included with a criminal judgment,' the facts underlying a restitution order need not be established beyond a reasonable doubt" (quoting United States v. Behrman, 235 F.3d 1049, 1054 (7th Cir. 2000))).

141. United States v. Newman, 144 F.3d 531, 538 (7th Cir. 1998) (internal citation omitted).

142. *George*, 403 F.3d at 473.

143. *See Newman*, 144 F.3d at 541 (finding that the "primary purpose of restitution is to compensate the victim of crime rather than to affect the criminal in some way").

144. *See* United States v. Einstman, 325 F. Supp. 2d 373, 382 (S.D.N.Y. 2004).

145. *See generally* 18 U.S.C. § 3583(e) (2000) (governing the options for a court to modify, extend, or revoke supervision); USSG, *supra* note 6, § 7B1.1.

depends on this premise.

### *C. Even Though Restitution Is Punishment, the Courts Do Not Apply the Sixth Amendment*

Presuming that restitution is criminal punishment, it might seem a foregone conclusion that the protections of the Sixth Amendment apply to decisions about restitution and, correspondingly, to the MVRA, which governs it.[146] Certainly, if restitution is punishment, and facts affecting punishment require a jury finding, then it would seem to follow that restitution determinations require a jury assessment. But the federal appellate courts have not made the issue so simple.

*1. The Federal Appellate Court Decisions Say That the Sixth Amendment Does Not Apply to Restitution.*—The Supreme Court has yet to decide whether *Booker* requires that a jury decide facts supporting an order of restitution and, in conjunction with that issue, whether the MVRA violates the Sixth Amendment because it defies such a process.[147] As of February 15, 2006, all of the circuits to specifically reach the issue (the Third, Fourth, Fifth, Sixth, Seventh, Eighth, Ninth, and Tenth), have held that the Sixth Amendment does not guarantee a defendant a jury trial or a beyond-a-reasonable-doubt review on issues of restitution.[148]

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146. This was the conclusion quickly reached in Kleinhaus, *supra* note 118, at 2763-64. *See also* United States v. Holland, 380 F. Supp. 2d 1264, 1278 (N.D. Ala. 2005) (finding that because in the Eleventh Circuit an order of restitution is punishment, restitution orders cannot be entered unless "a jury finds that the [g]overnment has met its burden of proving . . . that the defendant's conduct caused the victim's loss").

147. As of February 15, 2006, the First, Second, Eleventh, and D.C. Circuits have yet to directly address this issue. Other circuit courts were also slow to reach the issue. In several cases decided within the first year after *Booker*, the Eleventh Circuit skirted the Sixth Amendment issue, usually because the defendant failed to object in the district court; thus, the court applied a "plain error" standard and found that "[b]ecause neither the Supreme Court nor this Court has addressed whether *Booker* applied to restitution, any error cannot be plain." *See* United States v. Vernier, No. 03-10021-CR-SH, 2005 WL 2496118 (11th Cir. Oct. 11, 2005) (unpublished); United States v. King, 414 F.3d 1329, 1330-31 (11th Cir. 2005) (unpublished); United States v. Desoto, No. 04-12307, 2005 WL 901878 (11th Cir. Apr. 19, 2005) (unpublished). Although the Sixth Circuit had previously held that the rule in *Apprendi* did not invalidate the MVRA, in April, following *Booker*, the Sixth Circuit expressed "no opinion" on whether *Booker* invalidates the MVRA. *See* United States v. McDaniel, 398 F.3d 540, 554 n.12 (6th Cir. 2005). One district court from within the First Circuit ruled that the reasoning of *Booker* and the Sixth Amendment do apply to the MVRA. *See* United States v. Mueffelman, 400 F. Supp. 2d 368 (D. Mass. 2005).

148. *See* United States v. Leahy, No. 03-4490, 2006 WL 335806, at *1 (3d Cir. Feb. 15, 2006) (en banc) (concluding that restitution is not "the type of criminal punishment that evokes Sixth Amendment protection under *Booker*"); United States v. Garza, 429 F.3d 165 (5th Cir. 2005) (adopting, without any independent legal analysis, the rule from the Sixth Circuit and other "sister Circuits" that judicial fact-finding supporting restitution orders does not violate the Sixth Amendment), *cert. denied*, 74 U.S.L.W. 3486 (U.S. Feb. 27, 2006) (No. 05-8843); United States

In addition to the many circuits that have specifically rejected the application of *Blakely* and/or *Booker* to the MVRA, three circuits (the Third, Sixth, and Ninth) rejected application of the Sixth Amendment to restitution before *Booker*.[149] All three circuits have subsequently decided that the *Booker* decision does not change their earlier analyses.[150] The Third and the Ninth Circuits previously analyzed only the VWPA,[151] so the courts' analysis of the MVRA should arguably be different. Unlike the MVRA, under the earlier VWPA, restitution was not mandatory, and the sentencing court was required to consider the financial condition of the defendant when deciding whether or not to impose

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v. Nichols, No. 04-4060, 2005 WL 2224829, at *4 (4th Cir. Sept. 14, 2005) (unpublished) (holding that *Booker*, *Blakely*, and *Apprendi* do not affect the manner in which restitution is ordered); United States v. Sosebee, 419 F.3d 451, 461-62 (6th Cir.) (acknowledging that in the Sixth Circuit restitution constitutes punishment but, nevertheless, concluding that restitution is unaffected by the Supreme Court's ruling in *Apprendi* and *Booker*, reasoning that the restitution statutes contain no statutory maximum), *cert. denied*, 126 S. Ct. 843 (2005); United States v. Rattler, 139 F. App'x 534, 536 (4th Cir. 2005) (unpublished) (rejecting the defendant's restitution argument based on the Sixth Amendment and *Blakely*, holding that "there is no statutory maximum for restitution," and that neither the Sixth Amendment nor *Booker* apply to restitution); United States v. Rand, 403 F.3d 489, 495 n.3 (7th Cir. 2005) (finding that "restitution is essentially '[a] civil remedy included with a criminal judgment,'" not entitled to a beyond a reasonable doubt standard and, therefore, *Apprendi* and *Booker* do not apply (quoting United States v. Behrman, 235 F.39 1049, 1054 (7th Cir. 2000))); *see also* United States v. Agboola, 417 F.3d 860, 870 (8th Cir. 2005); United States v. Smith, No. 04-30161, 2005 WL 1793340, at *1 (9th Cir. Jul. 28, 2005) (unpublished) (holding, without analysis, that "*Booker* . . . does not affect restitution orders"); United States v. Pree, 408 F.3d 855, 875 (7th Cir. 2005) (holding that "the contention that *Booker* requires juries to assess restitution is misguided[;] that there is no 'statutory maximum' for restitution; [and that restitution] is not a criminal punishment"); United States v. Garcia-Castillo, 127 F. App'x 385, 391 (10th Cir.) (unpublished) (finding that restitution ordered under the VWPA and MVRA is not criminal punishment so *Blakely* and *Booker* do not apply), *cert. denied*, 125 S. Ct. 2951 (2005).

149. *See* United States v. DeGeorge, 380 F.3d 1203, 1221 (9th Cir. 2004) (rejecting without analysis the idea that the holding in *Blakely* applies to the VWPA, citing United States v. Baker, 25 F.3d 1452, 1456 (9th Cir. 1994), pre-*Apprendi* precedent that restitution determinations are not handled in the same manner as sentencing determinations under the USSG); United States v. Syme, 276 F.3d 131, 136 (3d Cir. 2002) (rejecting a defendant's argument based on *Apprendi* that a restitution order issued under the VWPA violated his Sixth Amendment rights, finding that the statute "contains no maximum penalty"); United States v. Bearden, 274 F.3d 1031, 1042 (6th Cir. 2001) (holding that *Apprendi* does not require a finding that the Sixth Amendment invalidates the MVRA, using the maximum fine as the relevant statutory maximum); *cf.* United States v. Ross, 279 F.3d 600, 609-10 (8th Cir. 2002) (noting that restitution is punishment and that restitution has no prescribed maximum, but avoiding a decision on whether *Apprendi* applies to restitution orders).

150. *See, e.g.*, United States v. Leahy, No. 03-4490, 2006 WL 335806 (3d Cir. Feb. 15, 2006); United States v. Sosebee, 419 F.3d 451, 461 (6th Cir. 2005) ("Given existing Sixth Circuit precedent and recent decisions of the other circuits on this issue, we now conclude that *Booker* does not apply to restitution."); United States v. Smith, 2005 WL 1793340, at * 1 (9th Cir. Jul. 28, 2005).

151. *See DeGeorge*, 380 F.3d at 1221; *Syme*, 276 F.3d at 136.

restitution.[152] But the Third, Sixth, and Ninth Circuits' post-*Booker* decisions show that the courts are not concerned with such distinctions.[153]

Perhaps it was predictable that the Seventh and Tenth Circuits would be quick to reject the idea that the Sixth Amendment applies to and invalidates at least parts of the MVRA. Both circuits had already decided that restitution is compensation to a victim, not punishment to a defendant.[154] As discussed earlier, if restitution is not punishment, then the rule in *Apprendi* does not apply. More surprisingly though, the Third, Fifth, Sixth, and Ninth Circuits, which recognize restitution as punishment, have also held that the Sixth Amendment is inapplicable to restitution.[155] And the Eighth Circuit, with no appreciable analysis, decided that in this context, restitution orders are civil remedies, not criminal punishment as the court had held in the ex post facto context.[156] Furthermore, the Seventh Circuit did not base its conclusion solely on the premise that restitution is not punishment. It went further. It held that the MVRA has no "statutory maximum" and concluded that the rule in *Apprendi* only applies when a factual determination exceeds a statutory maximum.[157] Based on this reasoning, the Seventh Circuit decided that the Sixth Amendment could not apply to the

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152. The MVRA has mandatory portions giving judges no choice but to order restitution and is unconcerned with a defendant's ability to pay. Thus, under the reasoning of *Booker*, which is directed at freeing judges' discretion from the mandatory nature of the Guidelines, this distinction is legally significant.

153. *See Leahy*, 2006 WL 335806, at *5 (concluding quickly that "the distinction between the permissive language of the VWPA and the mandatory language of the MVRA is immaterial" (internal citation omitted)); United States v. Bussell, 414 F.3d 1048, 1060 (9th Cir. 2005) (citing *DeGeorge*, 380 F.3d at 1221, for the idea that restitution is unaffected by *Booker*, without discussing the differences between the VWPA and the MVRA); *see also Sosebee*, 419 F.3d at 458-59, 461 (reviewing an order of restitution issued pursuant to the VWPA, but holding generally that *Booker* does not apply to restitution).

154. *See* United States v. Pree, 408 F.3d 855, 875 (7th Cir. 2005); *see also* United States v. Rand, 403 F.3d 489, 495 n.3 (7th Cir. 2005) ("Since restitution is essentially '[a] civil remedy included with a criminal judgment,' the facts underlying a restitution order need not be established beyond a reasonable doubt and thus are not governed by *Apprendi*, *Booker* and the other recent jurisprudence addressing sentencing issues." (quoting United States v. Behrman, 235 F.3d 1049, 1054 (7th Cir. 2000))); United States v. Garcia-Castillo, 127 F. App'x 385, 387 (10th Cir.), *cert. denied*, 126 S. Ct. 2951 (2005); United States v. Newman, 144 F.3d 531 (7th Cir. 1998).

155. *See supra* note 148.

156. *See* United States v. Agboola, 417 F.3d 860, 870 (8th Cir. 2005).

157. *See* United States v. George, 403 F.3d 470, 473 (7th Cir. 2005) (rejecting as "misguided" a defendant's contention that *Booker* requires juries to assess restitution, explaining that there is no statutory maximum for restitution); United States v. Swanson, 394 F.3d 520, 526 (7th Cir. 2005) (ruling that restitution orders do not come within the rule in *Apprendi* because there is no prescribed statutory maximum); *see also* United States v. Flaschberger, 408 F.3d 941, 943 (7th Cir.) (same), *cert. denied*, 126 S. Ct. 596 (2005). Other courts have since adopted this reasoning. *See, e.g.*, United States v. Rattler, 139 F. App'x 534, 536 (4th Cir. 2005) (unpublished); *Sosebee*, 419 F.3d at 461.

MVRA.[158] The Fourth, Fifth, and Sixth Circuits, which recognize the penal nature of restitution, have adopted the Seventh Circuit's conclusion with little or no meaningful analysis of their own.[159]

*2. The Appellate Decisions Rest on Flawed Assumptions.*—Neither Supreme Court precedent nor sound legal reasoning can sustain the conclusion that the MVRA contains no statutory maximum for purposes of *Apprendi/Booker* and the Sixth Amendment. The conclusion is flawed because it rejects the plain announcement from the Supreme Court that the "statutory maximum" for purposes of *Apprendi* does not mean the maximum embodied in the substantive statute but, rather, "the maximum sentence a judge may impose *solely on the basis of the facts reflected in the jury verdict or admitted by the defendant.*"[160] The appellate courts' conclusion also ignores the obvious cap or "statutory maximum" for restitution in every case. That maximum is "the full amount of each victim's losses."[161] Finally, the conclusion that the Sixth Amendment does not reach the MVRA overlooks the mandatory nature of the MVRA for certain crimes.[162] As demonstrated by *Booker*, the mandatory nature of a sentencing statute can present constitutional weaknesses.

While the Seventh Circuit's pre-*Blakely* decisions probably just underestimated the reach of the rule in *Apprendi*, the Seventh Circuit's legal analysis after *Booker* is simply unsound. The only logical, albeit unspoken, rationale for the Seventh Circuit's holding that *Booker* does not apply to the MVRA is that to do so would be impractical, which is the same worry expressed by Justice Breyer in his dissent in *Apprendi*.[163] That concern about impracticality

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158. *George*, 403 F.3d at 473; *Swanson*, 394 F.3d at 526.

159. *See Rattler*, 139 F. App'x at 536 ("We conclude that Rattler's restitution argument fails. Because there is no statutory maximum for restitution, the Sixth Amendment and *Booker* do not apply to restitution ordered by the sentencing court." (citing *Flaschberger*, 408 F.3d at 943)); United States v. Garza, 429 F.3d 165, 170 (5th Cir. 2005) (rejecting *Booker*'s application to the MVRA and citing the decisions in the Sixth, Seventh, Eighth, and Ninth Circuits), *cert. denied*, 74 U.S.L.W. 3486 (U.S. Feb. 27, 2006) (No. 05-8843); *Sosebee*, 419 F.3d at 461 (rejecting *Booker*'s application upon a finding that restitution statutes lack a statutory maximum).

160. United States v. Booker, 543 U.S. 220, 228 (2005); *see also* Blakely v. Washington, 542 U.S. 296, 303-04 (2004).

161. *See* 18 U.S.C. § 3664(f)(1)(A) (2000).

162. *See id.* § 3663A(a)(1) ("Notwithstanding any other provision of law, when sentencing a defendant convicted of an offense described in subsection (c), the court *shall* order, in addition to . . . any other penalty authorized by law, that the defendant make restitution to the victim of the offense." (emphasis added)); *see also* United States v. Szarwark, 168 F.3d 993, 997 (7th Cir. 1999) ("Under the MVRA, restitution is mandatory rather than discretionary for defendants convicted of certain offenses," and district courts "are no longer permitted to consider a defendant's financial circumstances when determining the amount of restitution to be paid.").

163. In his dissent in *Apprendi v. New Jersey*, 530 U.S. 466 (2000), Justice Breyer stated the following:

> [The rule announced by the majority] would seem to promote a procedural ideal—that of juries, not judges, determining the existence of those facts upon which increased

presumably led Justice Breyer to author Part Two of the majority decision in *Booker*, which undermined the holding in Part One.

*a. The "statutory maximum" fiction.*—The Seventh Circuit's erroneous conclusion that the Sixth Amendment does not apply to restitution,[164] because the MVRA has no statutory maximum, appears to have its genesis in pre-*Booker* precedent in that circuit, which held that the rule in *Apprendi* does not apply to the Federal Guidelines and is "limited to situations in which findings affect *statutory* maximum punishment."[165] In *United States v. Behrman*, the Seventh Circuit rejected a defendant's post-*Apprendi* argument that "unless a jury finds the essential facts [to support such restitution] beyond a reasonable doubt," the imposition of restitution in any amount is too much.[166] The court in *Behrman* said that the defendant's reliance on *Apprendi* "depend[ed] on a misunderstanding of that case. [The defendant] treats it as fundamentally changing the law of criminal sentencing, so that every fact affecting punishment must be treated as an 'element of the offense,' with all that implies in criminal law."[167] The Seventh Circuit construed the holding in *Apprendi* as limited to "situations in which findings affect *statutory* maximum punishment."[168]

In hindsight, after *Blakely* and *Booker*, it is clear that the Seventh Circuit's myopic view of *Apprendi*'s rule was wrong. The rule in *Apprendi* applies to the Federal Guidelines and, logically, applies equally to restitution ordered pursuant to the MVRA. At a minimum, *Blakely* and *Booker* show that the defendant's post-*Apprendi* argument in *Behrman* was right—every fact affecting punishment is the equivalent of an element of the offense "with all that implies."[169]

Even though *Blakely* and *Booker* highlighted the errors in the Seventh Circuit's *Behrman* decision, the Seventh Circuit has adhered to its flawed reasoning anyway. In fact, the court is building onto its "house of cards." In *United States v. George*,[170] the Seventh Circuit added to its misguided holding when it said, "There is no 'statutory maximum' for restitution, . . . so the sixth amendment does not apply. We have accordingly held that *Apprendi* . . . does not affect restitution, and that conclusion is equally true for *Booker*."[171] The Seventh Circuit did not explain why its reasoning from before *Booker* applies equally to

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> punishment turns. But the real world of criminal justice cannot hope to meet any such ideal. It can function only with the help of procedural compromises.

*Apprendi*, 530 U.S. at 555 (Breyer, J., dissenting). "*[J]udges*, rather than *juries*, traditionally have determined the presence or absence of such sentence-affecting facts . . . it is important to realize that the reason is not a theoretical one, but a practical one." *Id.* at 556.

164. This view was also subsequently adopted by the Fourth, Fifth, and Sixth Circuits. *See supra* note 159.

165. United States v. Behrman, 235 F.3d 1049, 1054 (7th Cir. 2000).

166. *Id.* at 1053.

167. *Id.* at 1053-54.

168. *Id.* at 1054.

169. *Id.*

170. 403 F.3d 470 (7th Cir.), *cert. denied*, 126 S. Ct. 636 (2005).

171. *Id.* at 473 (internal citations omitted).

cases after *Booker*. In short, the Seventh Circuit continues to misunderstand the Supreme Court's application of the Sixth Amendment and, therefore, still construes the Sixth Amendment to apply only when a sentencing court exceeds a *statutory* maximum, not any time that a defendant's punishment is increased above that approved by a jury's findings.

*b. The MVRA has limits.*—Applying its flawed legal analysis, which requires a search for the statutory maximum amount of restitution that a court can impose, the Seventh Circuit recently decided that restitution pursuant to the MVRA cannot exceed the *Apprendi* statutory maximum because the MVRA has no limit. The Seventh Circuit overlooks the obvious limit in every restitution matter. Although the MVRA does not provide a dollar cap on the amount of restitution a judge may order, it authorizes restitution only "in the full amount of each victim's losses."[172] In other words, the statutory maximum for purposes of the rule in *Apprendi* is the amount of loss to the victims from a defendant's crimes, no more and no less. Federal courts "possess no inherent authority to order restitution, and may do so only as explicitly empowered by statute."[173] Without the statutory authorization in the MVRA, a sentencing judge would have no power to order a defendant to pay restitution.[174] The MVRA does not authorize courts to direct defendants to pay more than the amount of loss resulting directly and proximately from the offense of conviction and does not permit courts to order defendants to pay restitution to anyone other than the victims of defendant's crimes (unless the defendant consents to such additional restitution).[175] When a judge orders restitution in any amount above the amount of the victims' losses reflected in the jury's verdict or admitted by the defendant, she violates the rule in *Apprendi* and *Booker*.

Thus, the only way to constitutionally determine the identity of victims and the amount of the victims' losses, unless the defendant admits those facts, is to let a jury decide these issues. The jury trial guarantee of the Sixth Amendment is vitiated if a judge is permitted to impose on a defendant punishment or restitution in a range which is "not solely based on 'facts reflected in the jury verdict or admitted by the defendant.'"[176] "[T]he relevant 'statutory maximum'

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172. 18 U.S.C. § 3664(f)(1)(A) (2000). The Eighth Circuit has recognized that even if statutes authorizing restitution have no prescribed minimum, "the full amount of restitution authorized by statute has its 'outer limits' which [are] determin[ed] by 'look[ing] to the scope of the indictment,' which in turn 'defines the scope of the criminal scheme for restitution purposes.'" United States v. Ross, 279 F.3d 600, 609 (8th Cir. 2002) (third bracket in original) (quoting United States v. Ramirez, 196 F.3d 895, 900 (8th Cir. 1999)).

173. United States v. Rand, 403 F.3d 489, 493 (7th Cir. 2005) (quoting United States v. Randle, 324 F.3d 550, 555 (7th Cir. 2003)).

174. *Id.*

175. *See* 18 U.S.C. § 3663(a)(1)(A) (2000) (authorizing restitution "to any victim"); *id.* § 3663(a)(2) (defining "victim" as a "person directly and proximately harmed as a result of the commission of an offense for which restitution may be ordered").

176. *See* United States v. Booker, 543 U.S. 220, 232 (2005) (quoting Blakely v. Washington, 542 U.S. 296, 303 (2004)).

is not the maximum sentence a judge may impose after finding additional facts, but the maximum he may impose *without* any additional findings."[177]

*c. Unlimited judicial discretion is unconstitutional.*—If the Fourth, Fifth, Sixth, and Seventh Circuits are correct that the MVRA has no "statutory maximum," that conclusion proves too much to protect the MVRA from unconstitutionality. Assuming there is no statutory maximum on restitution, then there is no limit on the sentencing judges' discretion. It is only when a judge "exercises his discretion . . . *within a defined range*,"[178] that a defendant "has no right to a jury."[179] Totally unfettered judicial discretion has never been constitutionally approved.[180] Unbounded discretion in the hands of the government is exactly what the Sixth Amendment is designed to protect against.[181] The Sixth Amendment ensures that the jury stands between a defendant and his government. That barrier is compromised when a judge has unlimited discretion to impose any amount of criminal punishment on a defendant.

The tension between the discretion lodged in a sentencing judge to impose an appropriate penalty on a defendant[182] and the defendant's constitutional right to have a jury of twelve find each fact that constitutes the crime with which the

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177. *Blakely*, 542 U.S. at 303 (quoting 1 J. BISHOP, CRIMINAL PROCEDURE § 87, at 55 (2d ed. 1872)). The holding of *Hughey* (albeit addressed to the VWPA, not MVRA) underscores the point that a sentencing judge is limited in the amount of restitution she may order. There, the Court expressly held that a sentencing court is not authorized to order a defendant to make restitution for losses resulting from offenses dismissed as part of a plea bargain. *See* United States v. Hughey, 495 U.S. 411, 412-13 (1990).

178. *Booker*, 543 U.S. at 233 (emphasis added).

179. *Id.*

180. Like the Federal Guidelines, the MVRA, "was intended to eliminate much of the discretion judges previously had in waiving restitution for certain types of crimes." *Federal Courts: Differences Exist in Ordering Fines and Restitution: Before the Subcomm. on Crime, H. Comm. on the Judiciary* 5 (1999) (statement of Richard M. Stana, Associate Director, Administration of Justice Issues, General Government Division, U.S. General Accounting Office), *available at* http://www.gao.gov/archive/1999/gg99095t.pdf. Interestingly, while restitution supposedly became mandatory pursuant to the MVRA, a study by the United States General Accounting Office, which was presented to a subcommittee of the House of Representatives in May of 1999, showed that the percentage of offenders ordered to pay restitution ranged greatly, from three percent to forty-nine percent, depending on which judicial district a defendant was sentenced in. *See id.*

181. *See* Apprendi v. New Jersey, 530 U.S. 466, 481 (2000) (noting that the Court's recognition of judges' broad discretion in sentencing "has been regularly accompanied by the qualification that that discretion was bound by the range of sentencing options prescribed by the legislature").

182. *See* Witte v. United States, 515 U.S. 389, 398 (indicating that as a general proposition, "a sentencing judge 'may appropriately conduct an inquiry broad in scope, largely unlimited either as to the kind of information he may consider, or the source from which it may come'" (quoting Nichols v. United States, 511 U.S. 738, 747 (1994))).

defendant is charged, is resolved by the "consistent *limitation on judges' discretion* to operate within the limits of the legal penalties provided[.]"[183] A sentencing court is not free to impose any sentence it chooses. Such unlimited discretion "exceed[s] the judicial estimation of the proper role of the judge[,]" and becomes "a 'tail which wags the dog of the substantive offense.'"[184] Given the mandatory nature of the MVRA, unlimited discretion to impose any amount of restitution presents the same type of Sixth Amendment problems presented in *Booker*. Applying the reasoning of *Booker*, such unfettered discretion violates the Sixth Amendment.

For all of these reasons, the Seventh Circuit and the other federal courts that rely on a similar reasoning are wrong to reject application of the Sixth Amendment to the MVRA.

## IV. A CONSTITUTIONAL AND EFFECTIVE SOLUTION FOR THE RESTITUTION PROCESS

If Part Two of the majority's opinion in *Booker*, the "remedy" portion, is any indication, even if the Supreme Court finds that the MVRA violates the Sixth Amendment, the Court might "remedy" that constitutional invalidity by striking only portions, like 18 U.S.C. § 3664(e),[185] that make the MVRA mandatory, to avoid the presumed impracticality that might result if defendants were truly afforded the guarantees of the Sixth Amendment.[186] Striking portions of the MVRA would not be a real remedy; it would be a partial patch on the sentencing process like the one the Court fashioned for the Federal Guidelines in *Booker*. As Professor Paul F. Kirgis recently put it, "the Supreme Court in *Booker* missed a critical opportunity to redress the constriction of the criminal defendant's right to have a jury decide those facts that lead to the deprivation of the defendant's liberty."[187] The fact that the MVRA conflicts with the Sixth Amendment shows that there is more wrong with the sentencing process than the invalid nature of the Federal Guidelines exposed in *Booker* and that the "remedy" crafted in Part Two of *Booker* is an ineffective one. It also underscores the need for revisions to the sentencing system to deal with the real problem—a lack of honesty in sentencing.

### *A. Congress Must Act*

The real and permanent fix to the way defendants are sentenced rests with Congress. This Article does not propose a solution to the entire sentencing

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183. *Apprendi*, 530 U.S. at 482 (emphasis added).

184. *See* Blakely v. Washington, 542 U.S. 296, 307 (2004) (quoting McMillan v. Pennsylvania, 477 U.S. 79, 88 (1986)).

185. *See, e.g.*, 18 U.S.C. § 3664(e) (2000) ("Any dispute as to the proper amount or type of restitution shall be resolved by the court by the preponderance of the evidence.").

186. *See* United States v. Booker, 543 U.S. 220, 245-46 (2005) (excising 18 U.S.C. §§ 3553(b)(1) and 3742(e) to strike out the mandatory nature of the Federal Guidelines).

187. *See* Kirgis, *supra* note 15, at 904.

scheme. It focuses on the MVRA and what Congress should do to make it comply with the Sixth Amendment. Congress should not only strike those portions of the MVRA that directly conflict with a defendant's right to trial by jury and proof beyond a reasonable doubt,[188] but also affirmatively enact provisions clarifying that defendants have such rights. Congress might look at the forfeiture provisions in the Federal Rules of Criminal Procedure ("Rules") when fashioning such a fix. In this regard, Congress should provide for a jury determination of restitution, upon either the defendant's or the government's request, much like Rule 32.2(a)(4) allows in the context of forfeiture.[189] As part of its legislative fix, Congress should also require that restitution be charged in the indictment or information, so that from the beginning of every federal prosecution the defendant is forewarned that the government is seeking restitution.[190] For instance, Rule 7(c)(2) provides that a judgment of forfeiture may not be entered in a criminal proceeding "unless the indictment or the information provides notice that the defendant has an interest in property that is subject to forfeiture[.]"[191] Similarly, Rule 32.2(a) requires that an indictment or information contain notice that the government will seek forfeiture in a criminal case.[192] Congress should adopt similar statutory provisions for restitution. Congress need not adopt all of the provisions applicable to forfeiture; in fact, the forfeiture procedures fall well short of affording all the rights guaranteed defendants by the Sixth Amendment.[193]

The intense need for congressional action is demonstrated by the post-*Booker* restitution decisions in which the courts have strained (through illogical analysis or, in some cases, no analysis) to limit the reach of *Booker*.[194] As compared to victims' rights, the constitutional rights of the accused are not popular. Thus, Congress may be just as unwilling as the federal courts of appeals have been to preserve the Sixth Amendment rights of defendants. Even if Congress does act to correct the current system of imposing restitution and thereby ensures

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188. *See, e.g.*, 18 U.S.C. § 3664(e) (calling for any dispute as to the amount or type of restitution to be resolved by the court by a preponderance of evidence); *id.* § 3664(f)(1)(A) (requiring the court to order restitution to each victim in the full amount of the victims' loss as determined by the court without consideration of the economic circumstances of the defendant).

189. *See* FED. R. CRIM. P. 32.2(a)(4) ("Upon a party's request in a case in which a jury returns a verdict of guilty, the jury must determine whether the government has established the requisite nexus between the property and the offense committed by the defendant.").

190. This suggestion is offered with the recognition that the issue of *Booker*'s impact on the holding in *Almendarez-Torres v. United States*, 523 U.S. 224 (1998), is still unknown, and *Booker* does not necessarily require such pleading.

191. *See* FED. R. CRIM. P. 7(c)(2).

192. *See* FED. R. CRIM. P. 32.2(a).

193. *See, e.g.*, FED. R. CRIM. P. 32.2(b)(1) (indicating that the *court* must determine what property is subject to forfeiture); FED. R. CRIM. P. 32.2(e)(3) (indicating that there is no right to a jury trial under Rule 32.2(e)).

194. *See, e.g.*, United States v. Sosebee, 419 F.3d 461 (6th Cir. 2005); United States v. Rattler, 139 F. App'x 534 (4th Cir. 2005); United States v. George, 403 F.3d 470 (7th Cir. 2005).

defendants a right to trial by jury and a heightened standard of proof, such a remedy will undoubtedly take time. In the meanwhile, a partial solution rests with the Department of Justice, the agency responsible for charging and prosecuting federal crimes, and with the courts that impose sentences.[195]

### *B. DOJ's Pre-Booker Policies Are Important Components in a Real Solution*

On July 2, 2004, eight days after the Supreme Court issued its decision in *Blakely v. Washington*, the Deputy Attorney General, United States Department of Justice, sent a memorandum to all federal prosecutors, outlining new legal positions and policies in the wake of that decision.[196] The prosecutors were instructed to "follow certain protective procedures in order to safeguard against the possibility of a changed legal landscape as a result of future court decisions."[197] With regard to charging cases, prosecutors were told to include in indictments "all readily provable Guidelines upward adjustment or upward departure factors (except for prior convictions that are exempt from the *Blakely* and *Apprendi* rules)."[198] In other words, in an effort to preempt the anticipated effects of *Booker*, prosecutors were instructed to change the way they charged, indicted, tried, and pursued sentencing of defendants to guard against the fact that the Sixth Amendment might require a jury to find all facts that supported sentencing enhancements. With regard to pleas, prosecutors were instructed to seek plea agreements "that contain waivers of all rights under *Blakely*."[199]

The practical result of the DOJ's change in policy was that from the beginning of every criminal case, there was complete candor in prosecution. Along with the change in the way crimes were charged, there was a corresponding change in the way crimes were indicted. A grand jury decided not only whether there was probable cause for the substantive "elements" of the crime, but also whether there was probable cause to support each ingredient that might increase a defendant's punishment at sentencing. Once arraigned on the indictment, the defendant was on full notice of what the government expected to prove at trial and the severity of the sentence the government would seek.[200]

In response to the change in the way the DOJ was charging cases, many

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195. Justice Stevens favored such a solution in his dissent in *Booker*. *See* United States v. Booker, 543 U.S. 220, 277 (2005) (Stevens, J., dissenting). Other legal scholars approve of it too. *See, e.g.*, Kleinhaus, *supra* note 118, at 2765.

196. *See* Memorandum from James Comey, *supra* note 13.

197. *Id.*

198. *Id.*

199. *Id.*

200. In his dissent to Part Two of *Booker*, Justice Stevens advocated for the DOJ's policy change. In this regard, he said, "I would simply allow the Government to continue doing what it has done since this Court handed down *Blakely*—prove any fact that is *required* to increase a defendant's sentence under the Guidelines to a jury beyond a reasonable doubt." *Booker*, 543 U.S. at 284-85 (Stevens, J., dissenting). After *Booker*, the DOJ returned to its old way of charging and sentencing crimes. *See supra* note 16.

district court judges adapted, too. During change of plea hearings, district courts routinely inquired about possible sentencing enhancements and the amount of restitution owed by the defendant.[201] Consequently, the government and defendants were forced to talk about these issues long before the sentencing hearing. Likewise, many district court judges bifurcated trials, asking the jury to address the statutory elements of the crime first and then, if the defendant was found guilty, to deliberate further on any potential sentencing enhancements.

Contrary to the many cries of doom that some predicted might cripple the criminal justice system if the Sixth Amendment was deemed to apply to sentencing issues, the system worked.[202] About as many defendants seemed to plead guilty. Almost as many pled guilty pursuant to a negotiated plea agreement. Most still agreed to waive their appeal rights, often including a waiver of the right to have sentencing enhancements determined by a jury by a beyond-a-reasonable-doubt standard. The biggest by-product of the DOJ's post-*Blakely* change in policy appeared to be the increased fairness of process. When defendants entered pleas, which they do in an extremely high percentage of all cases,[203] they did so voluntarily, knowing the potential punishment they faced, as Rule 11 expects. In all, the system fashioned by the DOJ in the post-*Blakely*, pre-*Booker*, era was probably slightly more time-consuming for both prosecutors and courts, and marginally more expensive, but it was a method that worked, and it ensured defendants the rights they are guaranteed by the Constitution. As the majority said in Part One of *Booker*,

> [I]n some cases jury factfinding may impair the most expedient and efficient sentencing of defendants. But the interest in fairness and reliability protected by the right to a jury trial—a common-law right that defendants enjoyed for centuries and that is now enshrined in the Sixth Amendment—has always outweighed the interest in concluding trials swiftly.[204]

Any perceived increase in burden on federal prosecutors to identify victims

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201. As noted by Justice Stevens in *Booker*, "45% of federal sentences involve no enhancements." *Booker*, 543 U.S. at 275 (Stevens, J., dissenting).

202. This conclusion rests primarily on the author's own observations as a prosecutor in the Northern District of Georgia. Although there are formal statistics compiled by the United States Sentencing Commission to compare pre-*Booker* and post-*Booker* statistics on the number of guilty pleas, sentencing departures, and similar information, the author was unable to locate any post-*Blakely*, pre-*Booker* statistics.

203. *See Booker*, 543 U.S. at 277 (Stevens, J., dissenting) (noting that plea agreements led to 97.1% of all federal cases sentenced under the Guidelines in Fiscal Year 2002). The post-*Booker* data compiled by the United States Sentencing Commission issued July 14, 2005, shows that 94.3% of all cases and 93.4% of all fraud cases (which often require restitution) were still resulting in a plea of guilty after *Booker*. *See* United States Sentencing Commission Special Post-Booker Coding Project, Cases Sentenced Subsequent to *U.S. v. Booker* (Data Extraction as of June 6, 2005) 43, 46 (July 14, 2005), *available at* www.ussc.gov/blakely/postbooker_060605extract.pdf.

204. *See Booker*, 543 U.S. at 244.

of a defendant's crime early and include that information within the indictment is now mitigated by the fact that prosecutors have to spend the time and effort to locate and contact victims anyway. Effective October 30, 2004, per the Justice for All Act, employees of the Department are required to make their best efforts to identify victims early in a prosecution to afford victims various rights, including the right to be present for public court proceedings and to be heard at plea hearings and sentencing hearings.[205] Because prosecutors are now obligated to make their best efforts to identify victims from the very beginning of every prosecution, the added burden of calculating restitution (at least in general terms) early and including it in the indictment is not overly burdensome.

Why should the Department take the lead in candor in charging and sentencing even after *Booker*, when so little has changed? As the Department of Justice emphasizes to every young prosecutor,

> The United States Attorney is the representative not of an ordinary party to a controversy, but of a sovereignty whose obligation to govern impartially is as compelling as its obligation to govern at all; and whose interest, therefore, in a criminal prosecution is not that it shall win a case, but that justice shall be done. As such, he is in a peculiar and very definite sense the servant of the law, the twofold aim of which is that guilt shall not escape or innocence suffer. He may prosecute with earnestness and vigor—indeed, he should do so. But, while he may strike hard blows, he is not at liberty to strike foul ones. It is as much his duty to refrain from improper methods calculated to produce a wrongful conviction as it is to use every legitimate means to bring about a just one.[206]

Pursuing honesty in sentencing is simply the right thing to do. It gives a defendant fair warning, protects the interests of victims, and still allows a culpable defendant to be held accountable for all of his criminal acts. In short, it promotes all the laudable principles underlying the Sixth Amendment, and the Department of Justice should lead the way by insisting on it.

### *C. The Lower Courts' Participation in the Solution*

The Supreme Court declared in *Hughey v. United States* that a defendant should be ordered to pay restitution only for loss amounts proximately resulting from offenses for which the defendant is convicted.[207] The concept seems so

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205. *See* Pub. L. No. 108-405, Title I, § 101, 118 Stat. 2260 (codified at 18 U.S.C. § 3771).

206. *See* Berger v. United States, 295 U.S. 78, 88 (1935).

207. *See* United States v. Hughey, 495 U.S. 411, 412 (1990). The holding in *Hughey* rested on the Court's statutory interpretation of the VWPA, not on constitutional grounds. *See also* United States v. Reichow, 416 F.3d 802, 805 (8th Cir. 2005) (noting that the VWPA and MVRA are similar and that *Hughey* requires that the loss be caused by specific conduct that is the basis of the offense of conviction).

basic; yet, it has not been strictly applied.[208] By applying the holding in *Hughey* to the MVRA, courts can preserve the Sixth Amendment. In ninety-four to ninety-seven percent of cases, (the ones that result in a plea of guilty), the courts can adhere to the *Hughey* rule by exploring restitution thoroughly at the change of plea hearing. In the few cases that proceed to trial, courts can use a special verdict form and/or a bifurcated jury process to have the jury identify how much restitution to order and to whom.[209] In these ways, courts can ensure that defendants are held accountable only for restitution proximately and directly resulting from the crime of conviction, unless additional losses are conceded by the defendant.

Since *Apprendi*, whether consciously or not, at least some federal courts have more readily enveloped the idea expressed by *Hughey* that there are limits on orders of restitution.[210] Even the Seventh Circuit, which has whole-heartedly

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208. This criticism does not ignore the fact that after *Hughey* the definition of "victim" was legislatively broadened. The criticism is directed at the fact that restitution has also reached conduct outside the statute of limitations and other incidental losses.

209. As illustrated by Professor Kirgis in his discussion of jury decision-making in civil cases, juries are accustomed and fully equipped to make difficult factual determinations. *See* Kirgis, *supra* note 15, at 935-42.

210. *See* United States v. Sosebee, 419 F.3d 451, 459 (6th Cir. 2005) (recognizing that the Supreme Court's decision in *Hughey* "establishes the outer limits of a restitution order" and generally prohibits a court from considering acts for which a defendant was not convicted). Furthermore, in *United States v. Flaschberger*, 408 F.3d 941 (7th Cir. 2005), the court remanded the sentencing court's decision on restitution for recalculation because the district court ordered the defendant

> to repay the whole sum . . . received between 1994 and 2001. Yet the only crime of which [the defendant] stands convicted is a scheme that, according to the indictment, spanned just three fiscal years: 1998-99, 1999-2000, and 2000-01. Unless a defendant agrees to pay more . . . restitution is limited to the crime of conviction.

*Id.* at 943 (citing 18 U.S.C. § 3663A(a) and *Hughey*, 495 U.S. 411); *see also* United States v. Inman, 411 F.3d 591, 596 (5th Cir. 2005) (finding plain error and remanding for correction of an order of restitution pursuant to the MVRA that "was based, in part, on transactions that were not alleged in the indictment and occurred over two years before the specified temporal scope of the indictment"); United States v. Fogg, 409 F.3d 1022, 1028 (8th Cir. 2005) (explaining that unless a charged offense includes a "scheme, conspiracy, or pattern of criminal activity as an element" that any restitution order may "only cover losses from the specific offense for which the defendant was indicted and convicted"); United States v. Ramsey, 130 F. App'x 821, 822 (7th Cir. 2005) (unpublished) (reversing district court's order to the extent it required a defendant convicted of two counts of using fraudulent cashier's checks with intent to deceive to pay restitution that exceeded the sum of cashier's checks involved in the only two counts (out of fourteen counts in the indictment) to which the defendant pled guilty, noting "the district court was empowered to order restitution only for the losses caused by the offenses of conviction because [the defendant]'s offense does not included as an element a 'scheme, conspiracy, or pattern,' and he did not agree to pay more as part of a plea agreement" (quoting 18 U.S.C. § 3553A(a))); United States v. Ross, 279 F.3d 600, 609 (8th Cir. 2002) ("[T]he full amount of restitution authorized by statute has its 'outer

rejected the application of *Booker* to restitution, recently reiterated that "restitution orders are subject to certain important strictures. The most basic of these is the requirement that there be a 'direct nexus between the offense of conviction and the loss being remedied.'"[211] The court also noted that "a restitution award is authorized only with respect to that loss caused by 'the specific conduct that is the basis of the offense of conviction,'"[212] and declared that "where a defendant enters a guilty plea, '[e]xamination of the conduct constituting the commission of a crime only involves consideration of the conduct to which the defendant pled guilty and nothing else.'"[213] The Seventh Circuit has even said that "'relevant conduct' . . . may not serve as the basis of a restitution award unless it is also 'charged conduct' or covered in a plea agreement."[214] By strictly applying the rule announced in *Hughey*, courts can help protect a defendant's Sixth Amendment rights by enforcing a policy of honesty in sentencing.

## CONCLUSION

The Supreme Court's January 2005 decision in *Booker* should induce Congress to enact legislation to remedy the constitutional invalidity of the MVRA and encourage the Department of Justice to revisit how restitution is charged, indicted, negotiated in plea agreements, proven at trial, and presented at sentencing hearings. The *Booker* decision is also a reminder to lower federal courts to adhere to the rule announced by the Supreme Court in *Hughey v. United States*, which limits the reach of orders of restitution. Congress, DOJ, and the federal courts should insist on candor in charging and sentencing to remedy the restitution roulette[215] that has generally accompanied a defendant through the federal sentencing process, a process which violates the Sixth Amendment and defies Rule 11 of the Federal Rules of Criminal Procedure. Restitution has been treated by sentencing courts as a post-conviction "afterthought." Because the

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limits,' which we determine by 'look[ing] to the scope of the indictment,' which in turn 'defines the scope of the criminal scheme for restitution purposes.'" (brackets in original) (quoting United States v. Ramirez, 196 F.3d 895, 900 (8th Cir. 1999))). *But see* United States v. Benjamin, 125 F. App'x 438, 442 (3d Cir. 2005) (stating that post-*Hughey* amendment to VWPA enabled district court to order restitution regardless of whether or not criminal conduct was charged in indictment).

211. United States v. Rand, 403 F.3d 489, 493 (7th Cir. 2005) (quoting United States v. Randle, 324 F.3d 550, 556 (7th Cir. 2003)).

212. *Id.* (quoting *Hughey*, 495 U.S. at 413).

213. *Id.* at 494 (brackets in original) (citing *Randle*, 324 F.3d at 556). Unfortunately, while the Seventh Circuit has begun to articulate the proper limits of restitution, as Part II of this Article shows, the circuit is still not adequately adhering to these principles.

214. *Id.* at 494 (quoting United States v. Scott, 250 F.3d 550, 553 (7th Cir. 2001)).

215. The Oxford American College Dictionary defines roulette as "a gambling game in which a ball is dropped onto a revolving wheel . . . with numbered compartments, the players betting on the number at which the ball comes to rest." THE OXFORD AMERICAN COLLEGE DICTIONARY 1181 (2002).

courts have treated restitution as a secondary matter, defendants have routinely pled guilty with no understanding of what they might face in restitution. Sentencing judges have ordered defendants to pay restitution to victims not identified in the indictment or information and in amounts not alleged in such charging documents. The Eleventh Circuit has even ordered a defendant to pay restitution for conduct that occurred beyond the statute of limitations.[216] These practices are analogous to those sentencing practices the majority condemned in *Blakely v. Washington*, "in which a defendant, with no warning in either his indictment or plea, would routinely see his maximum potential sentence balloon."[217] At a constitutional minimum, a defendant has a right to know the maximum sentence he faces, whether incarceration or restitution, when he goes to trial to defend himself and/or when he enters a plea under Rule 11 of the Federal Rules of Criminal Procedure. Restitution, like other forms of punishment, should never be arbitrary or unpredictable.

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216. *See* United States v. Dickerson, 370 F.3d 1330 (11th Cir. 2004); discussion *supra* Part I.

217. Of course, the majority in *Blakely* was referring to a defendant's period of incarceration, not an amount of restitution. *See* Blakely v. Washington, 542 U.S. 296, 311-12 (2004).

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# NOTES

## TRY TO VEST, TRY TO VEST, BE OUR GUEST: THE VESTED RIGHTS CONFLICT IN INDIANA CREATES A UNIQUE SOLUTION FOR ALL DEVELOPMENT*

TYLER J. KALACHNIK**

### INTRODUCTION

At the turn of the twentieth century, the United States was developing rapidly due to the construction of expanded transportation lines and a growing population.[1] The growth of the country has continued since that time, and a constant theme has been a large number of people seeking suitable land to meet their needs for shelter.[2] This is especially true in areas adjacent to metropolitan centers.[3] Early on, development followed no pattern and builders and speculators went wherever there was a housing or construction need.[4] Specifically, after World War I, decentralization of the American city intensified and "speculative uncontrolled development produced a new metropolitan fringe."[5] Furthermore, early in the twentieth century, the landowner's right to develop seemed almost unlimited as it sprang from what was believed to be an inherent right to put land to its best and highest use.[6] At that time, development was only restricted "by public nuisance law."[7] One early U.S. Supreme Court case held that only a "clear case of departure" from a permit or danger to the public could operate to arrest

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* The title is drawn from BEAUTY AND THE BEAST (Disney 1991) and *The Simpsons* (Fox).

** J.D. Candidate, 2006, Indiana University School of Law—Indianapolis; B.A., 2003, Indiana University, Bloomington. The inspiration for this Note came from a discussion with Timothy Ochs. I would like to thank Professor Dan Cole for his extremely helpful insight and support during the various stages of Note writing. I would also like to thank Shawner, Johnny, Beth, my grandparents, and friends and family for their support.

1. ROBERT H. WIEBE, THE SEARCH FOR ORDER 1877-1920, at 12 (Harper Collins 1967).
2. *Id.*
3. *See id.*
4. *Id.*
5. Eran Ben-Joseph, *Subdivision Regulations: Practices & Attitudes: A Survey of Public Officials and Developers in the Nations's Fastest Growing Single Family Housing Markets*, 2003 LINCOLN INST. LAND POL'Y 20-21.
6. Richard B. Cunningham & David H. Kremer, *Vested Rights, Estoppel, and the Land Development Process*, 29 HASTINGS L.J. 625, 630-32 (1978).
7. *Id.* at 632.

a developer in the midst of a construction project.[8]

Today the process of development and building is much more heavily regulated than during the nation's expansion in the late 1800s and early 1900s, but the demand for buildings is still present.[9] A respected scholar explains that one reason for the increased restrictions on development is the "increase in development itself."[10] The need to prevent nuisances is one underlying motivation for the increased regulation.[11] However, the desires of "more affluent newcomers" are the primary forces that result in more stringent regulation of development.[12] Due to this increasingly intense amount of regulation imposed by the government and citizenry, the issue of vested rights has become more important than ever.[13] A vested right ensures "certainty and fairness" to a developer so that he or she can be confident that a subsequently enacted regulation will not affect a project.[14]

In the law of vested rights, there are states that vest rights early in the development process and those that vest rights at a later point. Which one is Indiana? No one really knows. In Indiana there are two inconsistent lines of cases. One line of cases suggests that Indiana is an "early vesting" state. The other line suggests Indiana is a "late vesting" state. The time at which rights vest has become extremely important not just in Indiana, but in all states, because of large scale development projects like subdivisions and planned unit developments.[15] These developments have become increasingly prevalent and present difficult vested rights issues.[16] Large scale development has become the norm in recent years, with a majority of regions in the United States approving forty new subdivisions containing more than fifty units annually.[17]

One vested rights rule announced in Indiana cases seems to recognize this trend of larger and more complex developments and the risks to developers associated with such projects. Therefore, this rule vests rights at an early stage

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8. Dainese v. Cooke, 91 U.S. 580, 583-84 (1875).

9. David Hartman, *Risky Business: Vested Real Property Development Rights—The Texas Experience and Proposals for the Texas Legislature to Improve Certainty in the Law*, 30 TEX. TECH L. REV. 297, 299 (1999); *see* METROPOLITAN INDIANAPOLIS BOARD OF REALTORS & BUILDERS ASSOCIATION OF GREATER INDIANAPOLIS, HOUSING AND THE ECONOMY: STRIKING A BALANCE 3, 5 (2003) [hereinafter MIBOR]; *see* Gregory Overstreet & Diana M. Kirchheim, *The Quest for the Best Test to Vest: Washington's Vested Rights Doctrine Beats the Rest*, 23 SEATTLE U. L. REV. 1043, 1044 (2000).

10. WILLIAM A. FISCHEL, THE ECONOMICS OF ZONING LAWS: A PROPERTY RIGHTS APPROACH TO AMERICAN LAND USE CONTROLS 67 (John Hopkins University Press 1985).

11. *Id.*

12. *See id.*

13. Overstreet & Kirchheim, *supra* note 9, at 1044.

14. *Id.*

15. Grayson P. Hanes & J. Randall Minchew, *On Vested Rights to Land Use and Development*, 46 WASH. & LEE L. REV. 373, 404 (1989).

16. *Id.*

17. Ben-Joseph, *supra* note 5, at 16.

of development to protect the developer. Another line of Indiana cases, however, appears to contain an anti-developer bias by vesting rights very late in the development process and subjecting developers to more risk.

Vesting is usually viewed as an "all-or-nothing" battle with the government.[18] Investors in land development look to the vested rights doctrine as the "legal mechanism" that decides the winner "in the conflict between . . . property owner[s] and the local government."[19] The existence of a vested right to continue development will often be determinative of whether a project is a success or failure.[20] Without a clear vesting standard, developers are left in an environment of confusion and uncertainty which may discourage future development activity.[21] In addition, uncertainty can spur litigation and increase costs for developers and purchasers.[22] Furthermore, demoralization costs to developers are high when a risk exists that an investment in building could be lost because of a change in the law.[23] Investors are less likely to engage in development activity if their property can be taken by "frequent [unjustified] changes in the law."[24] Uncertainty seems inherent in the law of vested rights,[25] but certainly a state with two inconsistent vesting standards only adds to the confusion faced by a developer or landowner.

Part I of this Note examines the background of the doctrine of vested rights. Part II considers the various treatments of vesting and the point in time at which rights vest throughout the United States. Part III focuses on the current Indiana vesting rules and the cases which gave rise to those rules. Finally, Part IV of this Note proposes a unique solution for the time at which rights vest that attempts to differentiate between large and small developments. Also, Part IV gives guidance and justification for when a "late vesting" standard should apply as opposed to an "early vesting" standard.

## I. THE ORIGINS AND BACKGROUND OF VESTED RIGHTS

### *A. The History of Vested Rights*

Vested rights is a concept that developed in the English common law and

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18. Karen L. Crocker, Note, *Vested Rights and Zoning: Avoiding All-or-Nothing Results*, 43 B.C. L. REV. 935, 938 (2002).

19. Overstreet & Kirchheim, *supra* note 9, at 1055 (2000).

20. CHARLES L. SIEMON ET AL., VESTED RIGHTS: BALANCING PUBLIC AND PRIVATE DEVELOPMENT EXPECTATIONS 7 (Urban Land Institute 1982).

21. Ralph D. Rinaldi, Note, *Virginia's Vested Property Rights Rule: Legal and Economic Considerations*, 2 GEO. MASON L. REV. 77, 99 (1994).

22. *Id.*

23. Donald G. Hagman, *The Vesting Issue: The Rights of Fetal Development Vis A Vis the Abortions of Public Whimsy*, 7 ENVTL. L. 519, 534 (1976-1977).

24. *Id.* at 527.

25. John J. Delaney & Emily J. Vaias, *Recognizing Vested Development Rights as Protected Property in Fifth Amendment and Due Process and Taking Claims*, 19 WASH. U. J. URB. & CONTEMP. L. 27, 32 (1996).

has existed in American jurisprudence as a constitutionally protected legal interest for centuries.[26] The United States, however, had to reshape the law of England in order for it to function desirably in the very different geography and climate of the new world.[27] The English law was focused on land preservation during the Age of Discovery because much of the land in that country had already been put to use and exploited by the time the new world was discovered.[28] American judges had to create a body of law that would "encourage national development" of a landscape that was rugged and filled with "dense forests, tangled vegetation, arid plains, and lush wetlands" that were all viewed as an "obstacle to progress."[29] Several examples exist to support this proposition, including the narrowing of the English doctrine of waste, alteration of trespass and nuisance laws, and legal doctrines involving title that were crafted to suit American preferences for land use.[30] "[D]octrines governing title . . . were adjusted for wilderness land in a manner that tended to vest title in the industrious user rather than the idle claimant."[31] Thus, the courts fashioned laws that would favor the development of land over preservation of land.

In fact, in an Indiana Supreme Court decision dealing with a waste claim arising from the harvesting of timber, the court revealed an anti-wilderness bias.[32] The court announced that "a large portion of our territory consists of vast forests, requiring . . . that these forests should be turned into cultivated fields . . . [and this] makes the rule of the common law . . . wholly inapplicable."[33] Similar anti-wilderness sentiment existed throughout the rest of the nation.[34]

Vested rights continue to carry this "[a]ntiwilderness bias in American property law."[35] A developer who begins activity and investment in land will more likely be rewarded a right to continue development without government interference as opposed to a developer who does not commence development and investment until a later date.[36] For example, in many states it is more likely that a property owner with completed improvements on his property will be protected from rezoning, while an owner without any improvements will be subject to new

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26. SIEMON ET AL., *supra* note 20, at 52.

27. *See* Bernhard Grossfeld, *Comparative Law, Geography and Law*, 82 MICH. L. REV. 1510, 1519 (1984).

28. John G. Sprankling, *The Antiwilderness Bias in American Property Law*, 63 U. CHI. L. REV. 519, 523-24 (1996).

29. *Id.* at 523.

30. *Id.* at 526.

31. *Id.*

32. Dawson v. Coffman, 28 Ind. 220 (1867).

33. *Id.* at 224.

34. *See* Bradstreet v. Huntington, 30 U.S. 402, 448 (1831) (noting that the disputed uninhabited land was waste land); Davis v. Mason, 26 U.S. 503, 507 (1828) (describing a Kentucky parcel as a "pathless desert[]").

35. Sprankling, *supra* note 28, at 519.

36. *See* Hagman, *supra* note 23, at 527-28.

zoning laws.[37] History reveals that a notion exists that the right of a landowner to develop property should be protected. This is a simple enough proposition, but the challenge begins when deciding at what point a landowner should have his rights protected.

### *B. Explanation of Vested Rights*

A vested right is defined as "a right which the law recognizes as having accrued to an individual by virtue of certain circumstances and that as a matter of constitutional law cannot be arbitrarily taken away from that individual."[38] The law of vested rights balances, on one side, the competing interests of the individual's desire for "lower development costs" and certainty for investment purposes.[39] On the other side rests "the public's interest in controlling land-use and land-use planning [as exercised through the government's police power]."[40] Vested rights is really a mechanism which "draws a line between legislative flexibility and the power to regulate land use and a landowner's right to use, enjoy, and develop his property in a way that maximizes its value."[41] In determining on what side of this line a development will be placed, the law of vested rights focuses upon the acquisition of real property rights which are sufficient to continue with development without interference from subsequently enacted regulations.[42]

The vested rights doctrine attempts to provide certainty as to when a developer will be protected from any new government regulation.[43] Courts have concluded that, at some point during development, a level of commitment is reached at which time it would be unfair to halt any further development.[44] The doctrine developed from the law of nonconforming uses.[45] The doctrine makes

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37. *Id.*

38. Delaney & Vaias, *supra* note 25, at 31 (citing BRIAN W. BLAESSER ET AL., LAND USE AND THE CONSTITUTION: PRINCIPLES FOR PLANNING PRACTICE 8-9 (Brian W. Blaesser & Alan C. Weinstein eds., 1989)).

39. Hanes & Minchew, *supra* note 15, at 373; Thomas G. Pelham et al., *"What Do You Mean I Can't Build!?" A Comparative Analysis of When Property Rights Vest*, 31 URB. LAW. 901, 901 (1999).

40. Pelham et al., *supra* note 39, at 901.

41. Rinaldi, *supra* note 21, at 94; *see also* Ben-Joseph, *supra* note 5, at 2 (noting that planning authorities view regulations as their primary means for ensuring a minimum adequate level of quality in building).

42. 9 PATRICK J. ROHAN, ZONING AND LAND USE CONTROLS § 52D.01 (Eric D. Kelly ed., 1997) (1978).

43. *Id.*

44. *Id.*; *see also* Crocker, *supra* note 18, at 935 (explaining that "courts and legislatures use the vested rights doctrine to determine whether landowners have proceeded sufficiently far down the path of development of their land that the local government should not be allowed to enforce newly enacted zoning ordinances against them").

45. TRENDS IN LAND USE LAW FROM A TO Z: ADULT USES TO ZONING AND EVERYTHING IN-

guarantees that developers may proceed with a project unaffected by government interference after a certain point in the development process.[46] Of course property rights are not absolute, and a municipality must be able to enact new ordinances that affect landowners so as not to "preclude development and fix a city forever in its primitive conditions."[47] However, at some point it is necessary to give the developer assurance that the proposed project can continue without retroactive application of new zoning laws.[48]

In order for a landowner to acquire vested rights to develop, generally the "landowner will be protected when: (1) relying in good faith, (2) upon some act or omission of the government, (3) he has made substantial changes or otherwise committed himself to his substantial disadvantage prior to a zoning change."[49] Fledgling development rights must become vested rights to warrant "property" status, and when this status is obtained the vested development right cannot be affected by any new exercise of governmental police power.[50] The greatest confusion and conflict in gaining a vested right occurs when a developer has begun a project and a zoning ordinance is changed in the midst of development.[51] This situation can be especially taxing on a developer because portions of a project may be complete, but the new ordinance will apply to the entire project.[52] The new law will then require the developer to adjust the completed portions and suffer a monetary loss.[53]

Unfortunately, the vested rights doctrine is often a confusing morass of inconsistent decisions and arbitrary results.[54] In fact, one author has noted that "the only thing certain [about vested rights] is [that] an unjust result" will be produced.[55] Another author stated, "it often appears that the only time a developer has a true 'vested right' to develop is after he has literally established that right in concrete, the concrete of the building's foundation."[56] These sentiments surely create very serious concerns for developers of large projects

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BETWEEN 317 (Patricia E. Salkin ed., 2001).

46. *Id.*

47. Hadacheck v. Sebastian, 239 U.S. 394, 410 (1915); *see also* Curtiss v. City of Cleveland, 144 N.E.2d 177, 187 (Ohio 1957) (explaining that no landowner has a vested right to have the same zoning ordinance operate throughout his ownership).

48. *See* Cunningham & Kremer, *supra* note 6, at 647.

49. Delaney & Vaias, *supra* note 25, at 759; *see also* Hanes & Minchew, *supra* note 15, at 384.

50. Hanes & Minchew, *supra* note 15, at 385-86 (explaining that rights that have not become property rights may be taken by the government).

51. John J. Delaney & William Kominers, *He Who Rests Less Vests Best: Acquisition of Vested Rights in Land Development*, 23 ST. LOUIS U. L.J. 219, 220 (1979); *see also* DANIEL R. MANDELKER, LAND USE LAW 234 (3d ed. 1993).

52. *See* Delaney & Kominers, *supra* note 51, at 220.

53. *See id.*

54. *See* Cunningham & Kremer, *supra* note 6, at 625.

55. Hartman, *supra* note 9, at 318.

56. FISCHEL, *supra* note 10, at 23.

because of the large initial investment often required for complex projects.[57] As examined in Part II, some of the confusion and inequity that vested rights decisions produce may be a result of a number of different and imprecise applications of vesting standards in various jurisdictions.[58]

## II. THE SPECTRUM OF VESTING STANDARDS ACROSS THE UNITED STATES

Each state has adopted, through the common law or by enactment of a statute, "its own standard for [conferring] vested rights" upon deserving developers and landowners.[59] The difference in each standard can be found by examining the precise moment at which development rights become vested.[60] There are essentially three rules of vesting, and each state can be categorized as either a state which follows the majority rule, the minority rule, or the "early vesting" rule.[61]

### *A. The Late Vesting Majority States*

The majority or "late-vesting" rule provides that landowners will be protected when they have "reli[ed] in good faith upon an act or omission of the [] government by making a substantial expenditure[] or commitment[] prior to a change in the zoning law."[62] The common law in the states following the majority rule requires the "issuance of a building permit," plus substantial construction or other action in reliance upon the permit in order for development rights to vest.[63] The most essential element of a vested rights claim in a majority state is the developer's acquisition and possession of a building permit.

One illustration of the majority rule can be seen in an early Massachusetts case in which landowners obtained permits to build multi-family housing units.[64] The landowners began excavation, engineering work, and prepared to lay the foundation on their lots. After the permits were issued, a new zoning ordinance took effect which only allowed for single family homes in the area. The court held that the landowners did not have any vested rights to continue construction in light of the new zoning ordinance because the landowners had "only barely begun work pursuant to their permits."[65]

California, New York, and Maryland law also maintain a majority "late

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57. *See* Hanes & Minchew, *supra* note 15, at 403.

58. SIEMON ET AL., *supra* note 20, at 12.

59. Crocker, *supra* note 18, at 938.

60. *Id.*

61. *Id.*

62. *Id.* at 940; *see also* 3 ARDEN H. RATHKOPF, THE LAW OF ZONING AND PLANNING § 57-6 to -7 (4th ed. 1975); Gramiger v. County of Pitkin, 794 P.2d 1045, 1048 (Colo. Ct. App. 1989) (stating the majority rule does not grant vested rights absent substantial reliance on a valid permit).

63. Delaney & Vaias, *supra* note 25, at 32.

64. Brett v. Bldg. Comm'r of Brookline, 145 N.E. 269, 270 (Mass. 1924).

65. *Id.* at 271-72.

vesting" standard.[66] One frequently cited California case adhered to the majority rule so stringently that a developer who had incurred liabilities in excess of $700,000; costs of over $2 million for the construction of residential property; and had begun building storm drains, utilities, and streets in a proposed subdivision, had no vested rights because the developer had not yet obtained a building permit.[67] The court held that if a developer were permitted to gain a vested right to continue construction without a building permit, but instead by making substantial expenditures, there "could be serious impairment of the government's right to control land use policy."[68]

In order for rights to vest in New York and Maryland, there must be a substantial change in the land itself.[69] This is required even if a building permit has been obtained and substantial expenditures have been made.[70] For instance, Maryland cases frequently have held that a building permit gives its owner no vested rights in the current zoning classifications unless substantial construction has begun; thus, possession of a building permit combined with substantial expenditures for preliminary fees creates no vested right if there has not been any actual construction.[71] Similarly, one New York decision found no vested rights were created by the issuance of a permit and that actual construction was needed in order to vest rights, not merely substantial expenditures.[72] This test, used in Maryland and New York, is known as the "physical changes" test and looks for "actual and contin[uous] construction" with the intention to complete the building.[73] In jurisdictions following the "physical changes" test, it is difficult to discern the exact time at which construction was commenced.[74] Therefore, a builder not willing to undertake substantial construction without sufficient assurances that the project will be completed may have his development rights taken away very easily.[75] The developer's rights are vulnerable under the "physical changes" test because the court may find construction did not begin

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66. John J. Delaney, *Vesting Verities and the Development Chronology: A Gaping Disconnect?*, 3 WASH. U. J.L. & POL'Y 603, 607 (2000).

67. Avco Cmty. Developers, Inc. v. S. Coast Reg'l Comm'n, 553 P.2d 546, 554 (Cal. 1976). However, *Santa Margarita Area Residents Together v. San Luis Obispo County Board of Supervisors*, 100 Cal. Rptr. 2d 740, 746 (Ct. App. 2000), points out development agreements may be used to freeze development rights early in the development process.

68. *Avco Cmty. Developers, Inc.*, 553 P.2d at 554.

69. Delaney & Kominers, *supra* note 51, at 234.

70. *Id.*

71. Pemberton v. Montgomery County, 340 A.2d 240, 244 (Md. 1975); Prince George's County v. Equitable Trust Co., 408 A.2d 737, 743 (Md. Ct. Spec. App. 1979) (holding that vested rights could only be granted when a developer had obtained a building permit and begun substantial construction).

72. Gramatan Hills Manor, Inc. v. Manganiello, 213 N.Y.S.2d 617, 621 (App. Div. 1961).

73. Crocker, *supra* note 18, at 944.

74. Delaney & Kominers, *supra* note 51, at 235.

75. *Id.*

before the ordinance became effective.[76]

Other majority rule jurisdictions do not necessarily require actual construction but look to substantial investment or a balancing of interests in order to determine if rights have vested.[77] In order to determine if a developer has exhibited substantial reliance, majority rule states typically employ either a "proportionate/ratio test" or a "balancing test."[78] The proportionate/ratio test measures substantial reliance by comparing the amount spent on the project to the estimated total cost of the project.[79] If the expenditures represent a substantial percentage of the total cost then vested status is achieved.[80]

On the other hand, the balancing test considers the expenditures made on the project as only a factor and tries to "weigh the developer's right to use his land and the amount of money already spent on his development versus the public interests at stake in enforcing the new zoning ordinance."[81] The balancing test recognizes that no precise percentage or expenditure can be set to confer vested status upon a development.[82] Furthermore, it allows a court to look at the impact of the newly enacted ordinance with both an ex ante and ex post view.[83] The balancing test considers a number of factors including the "existing uses" in the area; the impact of the nonconforming use on property value; the public's health, safety, and welfare; net gain to the public and developer; and "the suitability of the property for zoned purposes."[84] The balancing test is more fact sensitive and thus is likely to produce a more equitable outcome.[85]

The majority rule has been criticized as being too harsh because it provides very little protection to property owners and often yields unjust results.[86] According to some, the majority rule allows the government very broad power in land regulation which may not be justified by the public interest.[87] The rule leaves the developer in a "no-man's land"[88] and there is a possibility that a permit may be denied at a late stage of development.[89] The rule makes the developer subject to the whims of the government and may tempt the developer to

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76. *Id.*

77. *See* Clackamas County v. Holmes, 508 P.2d 190, 192 (Or. 1973).

78. Crocker, *supra* note 18, at 944.

79. *See* MANDELKER, *supra* note 51, at 240.

80. City of Rochester v. Barcomb, 169 A.2d 281, 286 (N.H. 1961) (finding no vested right because a developer's expenditures in relation to the total costs of the project were insignificant).

81. Crocker, *supra* note 18, at 944.

82. *See* MANDELKER, *supra* note 51, at 240 (recognizing the balancing test as the preferred approach).

83. *Id.*

84. Delaney & Kominers, *supra* note 51, at 223 (citing Smith v. City of Macomb, 352 N.E.2d 697, 704 (Ill. App. 1976)).

85. *Id.*

86. Overstreet & Kirchheim, *supra* note 9, at 1062.

87. Pelham et al., *supra* note 39, at 912.

88. SIEMON ET AL., *supra* note 20, at 2.

89. Pelham et al., *supra* note 39, at 912.

"manipulate the process by prematurely engaging in [bad faith] activities [to] establish the substantial reliance required to vest his right to develop when inappropriate."[90] The majority rule can promote bad faith on the part of the government as well. It may encourage the government to quickly propose new zoning laws and satisfy the minimum public notice requirements, in the hopes that property owners will not find out about the new ordinance until it is enacted.[91] One scholar noted that a lack of a more precise vesting standard is "an open invitation to lawlessness[,]"[92] and one court has commented that the majority rule is the "handmaiden of . . . administrative anarchy."[93]

Nevertheless, the majority rule may be desirable for maintaining flexibility in controlling development and for what some see as fixing a clear and objective standard for the point at which rights vest.[94] The government or local municipality is able to maintain control until nearly the last moment in order to meet the needs of its citizens.[95] However, the majority rule is most likely unworkable for a large number of developments today because it is not suited for large scale development.[96] The majority rule originated in a time of "small-scale land development [proposals]" by individuals which took only a short time to construct.[97] In contrast, today developers have started pursuing more ambitious and complex projects that are multi-phased and involve a series of permits, reviews, and hearings.[98] This evolution makes the majority rule seem inadequate as a mechanism for determining when a developer has a protected right to continue construction on a particular project.[99] Often a development will require a large initial investment before a building permit is sought, and here the majority rule certainly falls short in protecting the developer by not accounting for pre-construction expenditures.[100] A more modern and realistic application of the majority rule would take into account pre-construction expenses because of the necessary investment of time and money in the conceptual, pre-construction stage of development.[101] While the majority rule may fail in circumstances involving multi-phased and investment intensive projects, its use should not be completely discarded, as this Note discusses in later sections.

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90. *Id.*

91. *See* Joel S. Russell, *Massachusetts Land-Use Laws—Time for a Change* (Jan. 2002), http://www.planning.org/PEL/masslaws.htm (last visited Mar. 7, 2006).

92. Donald G. Hagman, *Estoppel and Vesting in the Age of Multi-Land Use Permits*, 11 SW. U. L. REV. 545, 574 (1979).

93. Raley v. Cal. Tahoe Reg'l Planning Agency, 137 Cal. Rptr. 699, 711 (Ct. App. 1977).

94. *See* Crocker, *supra* note 18, at 955.

95. *See id.* at 956.

96. *See id.* at 955.

97. Cunningham & Kremer, *supra* note 6, at 626-27.

98. *Id.*

99. *Id.*; *see also* SIEMON ET AL., *supra* note 20, at 1.

100. SIEMON ET AL., *supra* note 20, at 1.

101. David G. Heeter, *Zoning Estoppel: Application of the Principles of Equitable Estoppel and Vested Rights to Zoning Disputes*, 1971 URB. L. ANN. 63, 91.

### *B. The Minority Rule States*

The minority rule permits a developer to obtain a vested right before a building permit is issued.[102] Unlike the majority rule, which requires building permit approval and issuance by the government, the minority rule defines government approval as "any site-specific approval, such as a preliminary plan."[103] Some states that are classified as "minority rule" states do not even require substantial reliance.[104] The minority rule allows development rights to vest to the effective zoning and building ordinances on the date the project is approved by the government, unless a compelling reason can be shown for retroactive application of an ordinance.[105] States following the minority rule have recognized that the majority rule often is unfair because it leaves too many matters in the development process open, which can result in unnecessary litigation.[106] At the same time, the rule attempts to leave some room for the government to make any necessary changes that are supported by a compelling public interest.[107]

Florida is one of the most liberal jurisdictions under the minority rule.[108] Florida courts have recognized vested rights in situations where the developer did not have a permit or had not made any physical changes to the land in reliance on existing zoning laws.[109] Similarly, New Jersey and Virginia have both enacted statutes which codify the minority view.[110]

New Jersey's statute confers specific rights upon a developer when the developer obtains preliminary approval for a major subdivision; the statute includes a provision that for a three year period, "the general terms and conditions on which preliminary approval was granted" will not change except for reasons of public health and safety.[111] Importantly, and perhaps in recognition of the failures of the majority rule to adequately protect large development projects, the New Jersey statute specifies that the statute applies to "[p]reliminary approval of a major subdivision."[112]

The Virginia statute protects against the impairment of any vested right by

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102. MANDELKER, *supra* note 51, at 237 (citing W. Land Equities, Inc. v. City of Logan, 617 P.2d 388, 395 (Utah 1980)).

103. Crocker, *supra* note 18, at 944.

104. *Id.* at 945.

105. Overstreet & Kirchheim, *supra* note 9, at 1045.

106. *W. Land Equities, Inc.*, 617 P.2d at 391.

107. *Id.* at 396.

108. Pelham et al., *supra* note 39, at 905-06.

109. *Id.*; *see* Town of Largo v. Imperial Homes Corp., 309 So. 2d 571, 574 (Fla. Dist. Ct. App. 1975) (finding the existence of vested rights where a developer entered into a contract to purchase land contingent on gaining desired zoning classification and such classification was granted).

110. Crocker, *supra* note 18, at 945.

111. N.J. STAT. ANN § 40:55D-49 (West 2004).

112. *Id.*

essentially codifying the elements of a common law vested rights claim.[113] In addition, the Virginia statute enumerates specific actions which will be deemed affirmative government acts, including when

> the governing body or its designated agent has approved a preliminary subdivision plat, site plan or plan of development for the landowner's property and the applicant diligently pursues approval of the final plat or plan within a reasonable period of time under the circumstances; . . . or the governing body or its designated agent has approved a final subdivision plat, site plan or plan of development for the landowner's property.[114]

Similar to New Jersey, Virginia specifically included subdivisions in its statute, which is likely in recognition that subdivisions and multi-phased projects are the "Achilles' heel" of the majority "late vesting" rule.

The minority rule is more certain and fair than the majority rule because, under the minority rule, "the regulations in effect at the time of project approval are applied."[115] Practically, the minority rule operates in states such as Virginia to provide limited certainty to the landowner so that, once government approval of a site plan is received, only non-discretionary approvals remain.[116] The minority rule nonetheless, is considered inadequate by some commentators because it still allows the government to pull the rug out from under the developer between the time of permit application and final approval.[117] The risk of loss of a substantial investment toward preliminary activities, such as surveying and contracting, persist under a minority rule regime because the protected vested right arises only after final application approval.[118] Thus, the time period between application and approval is fraught with uncertainty.[119] Unfortunately for the developer, the time between application and approval is the time during which the risk of loss and cost are most substantial.[120]

### *C. The Early Vesting States*

A "second minority rule" has developed in Washington, Colorado, Massachusetts, Utah, and Texas that grants vested rights even earlier than the minority rule.[121] The "early vesting" rule confers vested rights upon a developer on the date of application for a "site specific" permit.[122] Under this rule, there is

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113. VA. CODE ANN. § 15.2-2307 (2004).
114. *Id.*
115. Overstreet & Kirchheim, *supra* note 9, at 1065.
116. Hanes & Minchew, *supra* note 15, at 394.
117. Overstreet & Kirchheim, *supra* note 9, at 1065.
118. *Id.*
119. *Id.*
120. *Id.*
121. Crocker, *supra* note 18, at 949-50.
122. *Id.*

no requirement that the developer change his or her position in reliance upon a permit.[123] Therefore, no evidence of substantial investment is required.[124] Rather, the "early vesting" rule presumes that a sufficient amount of detrimental reliance has occurred in the form of preliminary expenses prior to application for a building permit.[125] Consequently, the rule allows rights to vest upon filing of a permit application.[126]

The "early vesting" rule is much more developer friendly in comparison to the other rules. The developer's right to a permit vests when the developer applies for the permit, and the development is permissible under the building codes and ordinances in effect at the time the permit application is made.[127]

The "early vesting" rule has been hailed as revolutionary, in that it allows the government to "exercise its reasonable health, safety, and welfare powers when necessary [while creating] a good balance between the needs of local government and property owners."[128] The rule allows the government to retain regulatory flexibility, yet gives property owners powerful protection of their right to develop.[129] Also, the rule minimizes the risk that any expenditure toward development will be wasted due to government interference.[130] The rule is able to accomplish this balance of developer and government rights by establishing a "date certain" for vesting.[131] The "date certain" is the date a proper application for a permit is filed.[132] Under the "date certain" doctrine, the enumerated uses in the permit accrue into vested rights upon the date a proper application is filed.[133] Washington courts have reasoned that this is a more practical and predictable rule.[134] Furthermore, advocates of the "early vesting" approach maintain that "the only government power sacrificed by [the use of an early vesting rule] is the ability of local politicians to retroactively prevent currently lawful—but politically unpopular—land uses."[135]

As an illustration of the "early vesting" rule, a landowner who simply

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123. RATHKOPF, *supra* note 62, § 57-4.

124. *Id.*

125. Lynn Ackermann, Comment, *Searching for a Standard for Regulatory Takings Based on Investment-Backed-Expectations: A Survey of State Court Decisions in the Vested Rights and Zoning Estoppel Areas*, 36 EMORY L.J. 1219, 1236 (1987).

126. *Id.*

127. RATHKOPF, *supra* note 62, § 57-2; *see* Allenbach v. City of Tukwila, 676 P.2d 473, 476 (Wash. 1984).

128. Overstreet & Kirchheim, *supra* note 9, at 1047, 1060.

129. *Id.*

130. *Id.* at 1062 (citing Frederick D. Huebner, Comment, *Washington's Zoning Vested Rights Doctrine*, 57 WASH. L. REV. 139, 162 (1981)).

131. *Id.* at 1073.

132. *Id.* at 1071.

133. *Id.* at 1069.

134. Valley View Indus. Park v. City of Redmond, 733 P.2d 182, 195 (Wash. 1987); Hull v. Hunt, 331 P.2d 856, 859 (Wash. 1958).

135. Overstreet & Kirchheim, *supra* note 9, at 1073.

proposed the development of a business and complied with all zoning provisions was held to have gained vested rights to develop his property, despite attempts by the municipality to prevent such use.[136] The court stated that "[a] building or use permit must issue as a matter of right upon compliance with the ordinance" and that "an owner of property has a vested right to put [land] to a permissible use as provided by prevailing zoning ordinances."[137] The rule clearly appreciates the trend toward longer and more expensive development processes by recognizing that substantial investment often occurs prior to application for a permit.[138]

Washington enacted a statute in 1987 which essentially codified the common law vested rights doctrine announced in *Ogden v. City of Bellevue*.[139] In addition, the statute extended protection to subdivisions, likely due to their special status as multi-phase developments.[140] For example, in *Noble Manor Co. v. Pierce County*,[141] the court applied Washington's vested rights doctrine to a subdivision and found that once a subdivision plat had been submitted, the landowner's rights to develop had vested.[142] The court found the development was immune to any subsequently enacted zoning change.[143] Thus, the "early vesting" rule appears to be the most fair rule when applied to expensive and lengthy development projects.

Nevertheless, the "early vesting" rule is criticized for being too developer friendly and leaving the government almost no flexibility to react to important community concerns and issues.[144] The rule could allow a developer who has manifested no sincerity in completing a development to freeze the zoning laws against the government.[145] Thus, the rule may allow the zoning laws to become obsolete in providing for the community's needs and desires.[146]

For instance, in the town of West Tisbury on Martha's Vineyard, Massachusetts, local authorities proposed a temporary moratorium on building permits for single-family homes.[147] Within the first six weeks after the proposal, the total number of building permits granted exceeded the number that had been given during the previous year.[148] The moratorium had the perverse effect of actually generating growth due to the advantage given to landowners under the

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136. Ogden v. City of Bellevue, 275 P.2d 899, 901-02 (Wash. 1954).

137. *Id.*

138. Rinaldi, *supra* note 21, at 95.

139. Noble Manor Co. v. Pierce County, 943 P.2d 1378, 1382 (Wash. 1997).

140. WASH. REV. CODE § 58.17.033 (1998).

141. 943 P.2d 1378.

142. *Id.* at 1382.

143. ROHAN, *supra* note 42, § 52D.03[2].

144. *See* Roger D. Wynne, *Washington's Vested Rights Doctrine: How We Have Muddled a Simple Concept and How We Can Reclaim It*, 24 SEATTLE U.L. REV. 851, 855 (2001).

145. Crocker, *supra* note 18, at 958.

146. *Id.*

147. Russell, *supra* note 91.

148. *Id.*

"early vesting" rule.[149] Thus, the possibility of bad faith behavior on the part of the developer is still present under the "early vesting" rule because developers may rush to begin a project to gain protection from any subsequent zoning amendment.

Clearly, there is jurisdictional conflict concerning vested rights. This leaves developers scratching their heads as to when they no longer have to be concerned with newly enacted ordinances.[150] The developer confusion can logically only become greater in a state such as Indiana, where two vesting standards currently exist.

## III. THE INDIANA PROBLEM

Indiana has placed itself in the unique position of becoming a vested rights "laboratory" for the entire United States. A series of nonconforming use cases seem to announce one vesting rule that is unfavorable to developers,[151] while a separate line of cases subscribes to a more developer friendly standard.[152] This is a troublesome development because the vesting rule is essentially an extension of the protections provided by the nonconforming use rule to partially completed development projects.[153] The vesting rules and nonconforming use rules should be compatible.[154] In Indiana, however, it seems impossible to view the rules together at the present time because the cases concerning vested rights sit at polar opposites. Indiana recognizes that property rights are not perfect and may be restricted by the government's police power,[155] but beyond this basic notion there exists much confusion.

### *A. The* Lutz *Case Line*

In one line of cases, Indiana appears to have adopted a vesting standard similar to the courts of Maryland and New York, which requires actual construction for a vested right to be conferred upon a landowner.[156] In *Lutz v. New Albany City Plan Commission*,[157] the owners of a parcel of land entered into a lease with an oil company. The lease called for the construction of a service station on the site. The owners entered into a loan for the station and applied for permission to build the station but the application was denied. After denial of the permit, the city enacted a new zoning ordinance which prohibited gasoline

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149. *Id.*

150. Delaney & Vaias, *supra* note 25, at 731.

151. Dandy Co. v. Civil City of South Bend, County City Complex, 401 N.E.2d 1380 (Ind. Ct. App. 1980); Lutz v. New Albany City Plan Comm'n, 101 N.E.2d 187 (Ind. 1957).

152. Bd. of Zoning Appeals v. Shell Oil Co., 329 N.E.2d 636 (Ind. Ct. App. 1975); Knutson v. State, 160 N.E.2d 200 (Ind. 1959).

153. Hagman, *supra* note 23, at 526.

154. *See id.*

155. Zahm v. Peare, 502 N.E.2d 490, 494 (Ind. Ct. App. 1985).

156. *See supra* notes 68-75 and accompanying text.

157. 101 N.E.2d 187 (Ind. 1951).

stations in the area where the parcel was situated.[158] The landowners contended they had a vested right because they had entered into a lease and had begun conversion of the parcel into a service station. The court held that the landowners had not gained any vested rights and stated, "where no work has been commenced, or where only preliminary work has been done without going ahead with the construction of the proposed building, there can be no vested rights."[159] In addition the court said, "the fact that ground had been purchased and plans had been made for the erection of the building before the adoption of the zoning ordinance prohibiting the kind of building contemplated, is held not to exempt the property from the operation of the zoning ordinance."[160] The court required actual construction in order for rights to vest and asserted that construction did not include purchasing a parcel and contemplating a use upon that parcel.[161] Furthermore, the court made clear that the lease which the landowners had entered into did not provide a basis for vested rights.[162]

The *Lutz* case implicitly states that, not only is substantial construction needed in order for development rights to vest, but a valid permit is also necessary. In fact, some scholars categorize Indiana as one of many states which require the issuance of a building permit and substantial reliance, "such as construction or expenditure of funds to implement the permit."[163] Thus, according to *Lutz* and certain scholarly analysis, it appears Indiana is a majority rule "late vesting" state.

The *Lutz* holding was reaffirmed in *Dandy Co. v. Civil City of South Bend, County-City Complex.*[164] In *Dandy Co.*, the owner of a parcel of land operated an adult bookstore which she later vacated. The premises remained dormant for two years until Dandy Co. signed a lease to operate the premises once again as an adult bookstore.[165] Subsequently, the city of South Bend enacted an ordinance which forbade certain types of uses, including adult bookstores, from being in close proximity to one another. Dandy Co. argued the ordinance could not apply to the store despite the lapse in the operation of the business.[166] The landowner and Dandy Co. offered evidence that a lease had been entered into before the ordinance was enacted and while the store was vacant. The court held no vested interest existed because no substantial liabilities had been incurred by either Dandy Co. or the landowner.[167] The court looked to the *Lutz* decision in determining whether a vested right had been created and found that no renovation

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158. *Id.* at 189.
159. *Id.* at 190.
160. *Id.*
161. *Id.* (defining construction as the act of building).
162. *Id.*
163. Delaney, *supra* note 66, at 607.
164. 401 N.E.2d 1380, 1384 (Ind. Ct. App. 1980).
165. *Id.* at 1381.
166. *Id.* at 1382.
167. *Id.* at 1384 (citing City of Omaha v. Glissman, 39 N.W.2d 828, 903 (Neb. 1949)).

had begun on the premises but merely "clean-up work."[168] Also, like the *Lutz* court, the *Dandy Co.* court found that "the mere execution of a lease does not create a vested right."[169] In addition, the court extended the *Lutz* holding, and in doing so further shaped Indiana's vested rights law by stating, "preliminary contracts are not considered to be substantial liabilities . . . and do not give persons a vested interest."[170]

The *Lutz* case was implicated once again in *Town of Avon v. Harville*.[171] In *Harville*, a landowner operated a "salvage recycling" business on two lots.[172] After the landowner had purchased each lot and began business operations upon those lots, the town enacted a zoning ordinance making the operation of junkyards in the landowner's district illegal. The landowner claimed he had gained a vested right in operating his business. However, the court found that he had not shown a legal use of the land before enactment of the ordinance.[173] The court looked to *Lutz* and found that the landowner had failed to provide any evidence of a vested right that would insulate his property from the newly enacted ordinance.[174] It is important that such a recent case relied upon the *Lutz* decision as it is in conflict with a competing standard which will be discussed later in this Note.

### *B. The* Shell Oil *Case Line*

Another line of Indiana cases that has emerged in the area of vested rights seems to have developed a standard that completely and utterly contradicts the decision of the *Lutz* court. In fact, commentators have acknowledged that Indiana follows this standard by documenting Indiana as a state that vests development rights when an application for a building permit is officially filed.[175] Indiana has been listed among "early vesting" states similar to Washington.[176] The primary case that has likely led scholars to conclude that Indiana is an "early vesting" state is *Board of Zoning Appeals of the City of Fort Wayne v. Shell Oil Co.*[177] The case relies upon a rule set forth in *Knutson v. State ex rel. Seberger*,[178] a case which postdates *Lutz* by only a few years.

In *Knutson*, a landowner sought governmental approval of a subdivision plat, but the plat was rejected by the town board.[179] The landowner appealed the

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168. *Id.*
169. *Id.*
170. *Id.* (citing County of Saunders v. Moore, 155 N.W.2d 317, 319 (Neb. 1967)).
171. 718 N.E.2d 1194 (Ind. Ct. App. 1999).
172. *Id.* at 1195.
173. *Id.* at 1200.
174. *Id.* at 1198.
175. SIEMON ET AL., *supra* note 20, at 27.
176. *Id. Contra* Delaney, *supra* note 66, at 607.
177. 329 N.E.2d 636 (Ind. Ct. App. 1975).
178. 160 N.E.2d 200 (Ind. 1959).
179. *Id.*

decision of the town board, and subsequently the town board adopted a new subdivision control ordinance. The new ordinance gave the planning commission the authority to approve subdivision plats. The town board claimed the suit was invalid because of the new ordinance, but the court held that the landowner had a vested right in the prevailing laws affecting his property at the time the suit was filed.[180]

Following the *Knutson* case, the court of appeals then decided *Shell Oil Co.*[181] In that case, a landowner entered into a lease agreement with Shell Oil Co. for the construction and operation of a service station on a parcel held by the landowner.[182] On the same date as the execution of the lease, Shell applied to the building commissioner for a building permit. Five days later, the city adopted an ordinance which prohibited the construction of any gasoline station for a period of six months. The ordinance was extended two times, each time for three months.[183] Although Shell had properly completed the permit application, it was not issued a permit. Shell contended it was entitled to a permit on the date of application. The *Shell Oil Co.* court found that the use listed in the permit was conforming and held that "[t]he right to use property in accordance with prevailing zoning ordinances accrues upon the filing of an application for a building permit; and an ordinance of substantive character cannot later operate to divest such right."[184] The court therefore found that Shell Oil Co. was entitled to a permit and the parcel was immune to the newly enacted ordinance.[185]

The holdings of the *Knutson* and *Shell* cases nearly parallel the "early vesting" rule currently followed by the Washington Supreme Court.[186] Later, the rule was used in *Yater v. Hancock County Board of Health.*[187] In *Yater*, a landowner-developer was building a subdivision and installing in-ground septic systems.[188] The landowner obtained permits for thirty-five of the forty-seven lots but was denied permits for the remaining lots due to a newly enacted ordinance. The new ordinance severely restricted installation of septic systems.[189] The landowner argued that, as owner of the remaining lots, he had a vested right to obtain the permits for installation of the septic systems. The landowner contended that a vested right existed because the subdivision had been approved before the zoning ordinance restricting septic installation had taken effect. The *Yater* court looked to *Shell Oil Co.* for guidance and held that "[t]he right to use

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180. *Id.* at 201.

181. 329 N.E.2d 636.

182. *Id.* at 637.

183. *Id.* at 639.

184. *Id.* at 642 (citing *Knutson*, 160 N.E.2d at 202).

185. *Id.*

186. *See* RATHKOPF, *supra* note 62, § 57-4 to -6 (noting that Indiana courts have reached similar results as Washington courts).

187. 677 N.E.2d 526, 529 (Ind. Ct. App. 1997).

188. *Id.* at 528.

189. *Id.*

property under prevailing regulations accrues with the application of a permit."[190] When the court applied the *Shell Oil Co.* standard it determined that, because the landowner had not applied for the permits with respect to the remaining lots, he had gained no vested rights.[191] Thus, the property was subject to the new ordinance.[192]

An examination of the *Shell Oil Co.* case, its predecessor, and subsequent decisions point to a vested rights formulation that is more in line with "early vesting" states and therefore much more developer friendly. These cases seem to announce that only a proper application for a permit is needed in order for rights to become vested. The *Lutz* case line and the *Shell Oil Co.* case line are in conflict and a recent case calls for examination of the vesting disparity in Indiana.

### *C. A Billboard Case Inspires Examination*

The recent Indiana case that illustrated a need for an assessment of the competing Indiana vesting standards, and inspired this Note, was *Metropolitan Development Commission of Marion County v. Pinnacle Media, LLC.*[193] The case involved the siting of billboards in the city of Indianapolis and was the cause of a great deal of controversy throughout the state of Indiana. The case itself has larger implications that extend beyond the state of Indiana. The circumstances of the case may provide a unique solution to the confusion surrounding vested rights throughout the United States.

To begin, in the early part of the twentieth century and continuing into the present day, cities began reacting to the proliferation of billboards throughout their landscape.[194] Cities attempted to restrict construction of billboards through various ordinances.[195] Initially, courts were not willing to uphold billboard regulations if they were based on aesthetic concerns, but more recently, courts have found that aesthetic concerns are legitimate and within the scope of the police power.[196] Indianapolis, like other cities, recently found itself combating billboards when they began to clutter the scenery of the city in many locations.[197]

The mass of billboards was due in large part to a loophole Pinnacle Media, LLC had found in the city's municipal code.[198] The loophole allowed the

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190. *Id.* at 529.

191. *Id.*

192. *Id.*

193. 811 N.E.2d 404 (Ind. Ct. App. 2004).

194. *See* Katherine Dunn Parsons, *Billboard Regulation After* Metromedia *and* Lucas, 31 HOUS. L. REV. 1555, 1558 (1995).

195. *See id.*

196. *Id.* at 1560 (citing Ness v. Albert, 665 S.W.2d 1, 2 (Mo. Ct. App. 1983); Berman v. Parker, 348 U.S. 26, 32 (1954)).

197. John Strauss, *Billboard Outcry Is Sky-High as Panel Examines Ordinance*, INDIANAPOLIS STAR, Oct. 15, 2003, at B01.

198. John Strauss, *Duke Realty Is Dragged into Battle over Billboards*, INDIANAPOLIS STAR, May 30, 2003, at B01.

company to obtain permits for construction of billboards at certain sites and, at the same time, avoid the normal permitting process.[199] The typical business cycle for Pinnacle would begin when the company would lease land from a landowner, then obtain the necessary permits from the State and/or local authorities.[200] Finally, Pinnacle would erect billboards and lease the signs for advertising purposes to various entities.[201]

In 1999, Pinnacle entered into a lease with a landowner to build two signs on property that consisted of a railroad corridor which passed under an interstate. Pinnacle then sought the necessary permits for construction of the billboard. During the course of reviewing the permit applications, the Indianapolis Department of Metropolitan Development ("DMD") found that the land which Pinnacle had leased was not zoned. Therefore, the land was not subject to local authority nor was it controlled by the State of Indiana. "The land underneath and immediately adjacent to freeways is owned by the State . . . [with] the only exceptions [being] tiny slivers of land where the freeway intersects a railroad corridor."[202] Thus, the DMD lacked the jurisdiction to rule on the permits or to require that Pinnacle obtain the permits. The DMD advised Pinnacle to contact the Indiana Department of Transportation ("INDOT"). After learning that the City lacked jurisdiction over the site of the proposed billboards, Pinnacle acted upon the advice of the city and requested permits from INDOT. The State issued the permits and Pinnacle constructed two signs in accordance with the lease.[203]

Apparently realizing that the inherent administrative costs and long time delays of the government approval process could be avoided by developing these railroad parcels, Pinnacle pursued more leases for similar property in Indianapolis. Pinnacle succeeded in entering into fifteen additional leases at similarly situated sites.[204] The citizens of Indianapolis objected to Pinnacle circumventing the normal zoning process and feared that the loophole would lead to more billboards.[205] Once the leases had been secured, Pinnacle applied to INDOT for additional permits for each of the fifteen sites. During the time the permits were pending, city officials introduced and adopted an ordinance that zoned the areas containing the interstate railroad corridors.[206] The result of the new ordinance was that any developer in the railroad corridors would have to seek a building permit from the DMD. Subsequently, ten of the fifteen permits for which Pinnacle had applied were granted by INDOT. Pinnacle began construction on a site after gaining permit approval, but shortly after work began the DMD posted an "Order to Stop Work" for failure to obtain an "Improvement

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199. *Id.*

200. Metro. Dev. Comm'n of Marion County v. Pinnacle Media, LLC, 811 N.E.2d 404, 406 (Ind. Ct. App. 2004).

201. *Id.*

202. *Id.* at 407 n.5.

203. *Id.* at 407.

204. *Id.*

205. Strauss, *supra* note 198.

206. *Pinnacle Media*, 811 N.E.2d at 408.

Location Permit" for the sign from the city pursuant to the newly enacted ordinance.[207] Pinnacle argued that the ordinance could not be retroactively applied to the signs that had permit approval from the State and contended the "Stop Work Order" was void and unenforceable.

Eventually, the issue reached the Indiana Court of Appeals where the trial court's grant of Pinnacle's motion for summary judgment was upheld.[208] The court of appeals relied upon the *Shell Oil Co.* case line to resolve the dispute and held, "[o]nce a property owner applies for the relevant building permits under the prevailing zoning laws, the owner's rights vest as against other government units who subsequently attempt to intervene by enacting laws to assert jurisdiction . . . over the subject matter of the pending permit applications."[209] The court looked to *Knutson* as well and stated that if the government was authorized to apply subsequently enacted zoning ordinances not known to the landowner at the time of permit application there would exist "a government by men, and not by law."[210]

Ultimately, the court decided that the vested rights doctrine operated to prevent the city from interfering with the construction of the billboard.[211] By doing so, the court essentially subscribed to a rule consistent with *Shell Oil Co.* and the "early vesting" law of the state of Washington. This latest chapter in Indiana's vested rights saga only created more confusion. Which rule can developers rely upon with assurance that it will be consistently applied? How can the government maintain control and power of land without gaining too much of an advantage with *Lutz* in its back pocket? Indiana would be wise to resolve these seemingly contradictory standards.

This Note examines the proposed structure in *Pinnacle Media*, a billboard, and finds it especially useful to focus on it to reconcile the two lines of Indiana cases.[212] In fact, sometimes a single proposed development may change public policy and regulation.[213] The proposed billboard in *Pinnacle Media* could have the effect of redefining vested rights rules throughout the United States because of its small, less development-intensive nature. The billboard exposes the strengths and weaknesses of the vesting rules and indicates that one rule is better suited for complex and lengthy projects, while another is more appropriate in small, less development-intensive projects.

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207. *Id.*

208. *Id.* at 413.

209. *Id.* at 411.

210. *Id.* (quoting Knutson v. State *ex rel.* Seberger, 160 N.E.2d 200, 202 (Ind. 1959)).

211. *Id.*

212. This Note does not raise the possibility that Pinnacle was unfairly singled out but proceeds on the belief that the proliferation of billboards was a general concern with Pinnacle as one of many builders affected. *See* Cunningham & Kremer, *supra* note 6, at 668-69 (explaining that although a specific project may create legislative awareness of a problem it does not make the new law wholly inapplicable to the project).

213. SIEMON ET AL., *supra* note 20, at 7.

## IV. ANALYSIS AND SOLUTION

The most frustrating aspect of vested rights jurisprudence is the inconsistency and lack of a bright line test. This is due, in part, to the fact that land use regulations are always changing because of "man's understanding of his relationship with his environment and the political process that translates that understanding into policies."[214] Therefore, the different vested rights rules have developed in response to various situations where a new standard was necessary.[215] At some point, courts encountered situations where it would have been inequitable to deprive the landowner of vested rights and fashioned new rules to protect the landowner.[216] This resulted in the various rules that currently exist.[217] Thus, it can be argued that the individual vesting rules are each useful in the face of different circumstances.

Instead of adhering to a single test, states should retain multiple vesting rules and apply the relevant standard according to the nature and circumstances surrounding the development. Retention of two rules would require an initial inquiry into a set of factors to determine which rule will govern the proceeding. This would allow all relevant factors to be examined and would give the landowner two opportunities to avoid application of the new zoning ordinance. The landowner could satisfy the criteria that result in application of an "early vesting" rule or simply begin construction at an early date. At the same time, this solution lets the government maintain its power to affect certain projects through application of the "late vesting" rule. When the developer does not meet the criteria for an application of the "early vesting" rule, the more government-friendly "late vesting" rule will determine if a vested right has been acquired.

This bifurcated approach arguably could lead to increased administrative costs. Once the rule is instituted, uncertainty will likely exist regarding development projects which do not clearly fall on either side of the proposed factors. To resolve this "gray area," courts will necessarily have to draw lines so that unmistakable boundaries emerge with regard to certain projects. Nevertheless, some uncertainty may still exist because the proposed factors make every case fact sensitive.

However, any increased administrative costs may be exaggerated. Even if the feared costs are realized, they are justified in the end. Developers will lose large initial investments less often, and the public will not face the prospect of a wasted parcel containing a partially completed project. This is because, under a bifurcated system, the developer who is challenging the zoning change will more likely have the correct rule applied to the development circumstances. The bifurcated approach in many ways is like running a diagnostic before surgery is performed. By running a diagnostic, incorrect or unnecessary surgery is avoided. Here, an examination of the factors serves as the diagnostic. A bifurcated

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214. *Id.* at 6-7.

215. *See* Heeter, *supra* note 101, at 91.

216. *See id.*

217. *See id.*

approach will lead to correct application of a vesting rule, which in turn will make an unjust result less likely. Because an inequitable result will be avoided, the developer will not be unfairly deprived of his initial investment.

The initial examination of the factors in the bifurcated approach is analogous to a motion in limine. Motions in limine streamline the trial process by determining complicated issues early in the proceeding.[218] The proceeding can then continue in the most efficient and equitable manner because the scope of the proceeding has been established. Similarly, the initial examination of factors will control which vesting rule is appropriate. The court can then reach the most equitable decision because the correct rule will already have been selected. In this way, the process will be streamlined because the court will only have to apply an "early" or "late" vesting rule. Instead of attempting to bend a single rule in a situation that would otherwise result in unfairness to the developer, the applicable vesting rule will be clear from the beginning. Any increased administrative cost will likely be outweighed, not only by savings to the developer and the community, but also by the administration of justice.

Considering that the trend toward earlier vesting developed in the era of large subdivision development, the notion of retaining two vesting standards is especially workable. This is because small, less complex projects are still undertaken, along with larger projects. Since the 1970s there has been an overwhelming escalation of the complexity of regulation and the "size of development projects."[219] For example, Indianapolis, Indiana, alone granted 17,056 single family building permits between 1996 and 2000, making it the jurisdiction issuing the greatest number of permits in the Midwest.[220] This also indicates that a great number of sizeable subdivisions were planned or constructed during that period.[221] As a result of the demand for more housing, "pressures for planned, mixed use communities, political pressures for developer funding of large scale infrastructure improvements, and economic pressures for economy-of-scale cost savings, landowners today frequently propose large mixed-use development projects that will require years and perhaps decades of full-time planning and construction before completion."[222] Yet, as *Pinnacle Media* demonstrates, developers still undertake smaller projects frequently.

There is a range of variation in development, and therefore, different vesting rules should be applied according to varying development circumstances. As mentioned previously, the more complex the development, the more likely a greater substantial investment will be required before a developer even applies for a building permit.[223] Complex development projects require greater protection in part because they carry a greater risk of a lost investment. Increased

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218. James J. Brosnahan, *Motions in Limine in Federal Civil Trials*, A.L.I.-A.B.A. COURSE OF STUDY 213, 219-220 (Feb. 28, 2001).

219. Hanes & Minchew, *supra* note 15, at 404.

220. Ben-Joseph, *supra* note 5, at 54.

221. *See id.*

222. Hanes & Minchew, *supra* note 15, at 403-04.

223. ROHAN, *supra* note 42, § 52D.04[1].

complexity and cost in development persuaded some courts to adopt an "early vesting" standard because of the perceived inequitable results the majority rule caused many large scale developers to suffer. Recognition of special treatment for larger and more complex development is also seen elsewhere. Many courts will now vest rights when a final subdivision plat approval is relied upon, or even a preliminary subdivision plat approval.[224]

Additionally, in California, the Vesting Tentative Map statute[225] provides that a developer who submits a subdivision map which is approved gains a vested right to proceed with the development under the laws in effect at the time of submission.[226] The statute is based on the notion that a developer should be able to rely on an approved plat map before making substantial expenditures.[227] The same principle, which is based on certainty, is recognized internationally as well. The United Kingdom has a system, similar to the California statute, which calls for the submission of an outline of the essential parts of the development.[228] Once permission is granted based on the outline, only aesthetic and minor details of the project can be changed by the police power.[229] However, the English law is more complete than the California statute because it vests rights to the entire project.[230] Contrastingly, the California statute only vests rights to the permit for which the developer applied.[231]

Obviously the majority "late vesting" rule is less than perfect, and its shortcomings have been recognized in the United States and abroad. However, the "late vesting" rule is still useful for those development activities that do not require the same level of time and investment as larger projects. In addition, a "late vesting" rule results in "fewer nonconforming uses which is good for public health, safety, and welfare" and deters bad faith on the part of developers.[232]

This Note now undertakes the task of devising a system by which two rules of vesting may co-exist. Simply put, the goal of a vested rights rule or test is to allow developers to organize their economic behavior to encourage investment and allow them to gain protection in order to complete development.[233] A vested

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224. *Id.* § 52D.03[2]; *see also* Hanes & Minchew, *supra* note 15, at 404-05 (stating that a limited number of states have recognized that large complex projects require a different vesting standard).

225. CAL. GOV'T CODE § 66426 (West 1994).

226. Overstreet & Kirchheim, *supra* note 9, at 1067.

227. *Id.*; CAL. GOV'T CODE § 66426.

228. Hagman, *supra* note 23, at 542-44 (citing Town & Country Planning Act 1971, c. 78, 542; Town and Country Planning General Development Order 1973, No. 31 § 5(2)).

229. *Id.* at 543 (noting that after submission and approval of the outline the developer can recover damages if approval is revoked).

230. *Id.* at 544.

231. *Id.* (explaining that because the California statute only vests rights to a permit, the protection provided to the developer of a multi-permit project is minimal).

232. *Id.* at 530. *But cf.* FISCHEL, *supra* note 10, at 64 (noting that studies have found the presence of nonconforming uses have little effect on residential property values).

233. *See* MANDELKER, *supra* note 51, at 234.

rights standard also needs to preserve government power to protect local communities. A clear vested rights standard provides a measure of certainty for developers so that they do not fear the risk of losing their investment, and as a result of this fear, curtail development activities.[234] If the developer is apprehensive because of possible government interference, lower production and increased risk may lead to higher costs for buildings passed on to purchasers.[235] Concern over increased cost to consumers is not unfounded. A majority of developers responding to a national survey indicated that government regulation was responsible for at least a five percent increase in the purchase price of subdivision homes.[236]

A system containing two rules, or a bifurcated approach, would minimize the uncertainty faced by developers because it is more likely that the correct rule would be applied. Also, the bifurcated approach does not strip the government of the power needed to properly regulate development. Several factors are to be used in order to create certainty in the developer's mind as to what actions need to be taken in order to gain vested rights. The factors can be analyzed individually and the result of each analysis bears on which vesting rule to apply. If the factors are all accounted for and it is decided the development is one that is deserving of great protection, the developer or court will look to whether a proper application for a permit has been filed. If such an application has been submitted, then rights will vest under the "early vesting" rule. On the other hand, if the factors indicate that the development is one that is not worthy of the utmost protection, the developer or court will look to whether substantial construction has begun under the "late vesting" rule.

The factors promulgated are ones that the developer may examine himself or herself to understand what actions need to be taken to gain vested rights. The developer can ask self-critical questions to which the developer can easily find the answer, such as, "Is this the best use of the land in this community?"; "How much have I invested in the project compared to the overall cost?"; and "How many permits are required for this project?" The basic design of the solution is fairness because "the test of fairness . . . to some extent has always served . . . as a guide to public policy."[237] The solution also attempts to include points of inquiry that are not just focused on the developer, but the community as well because "[t]o ignore the bilateral nature of justice in property cases is, in truth, the deepest of ironies."[238] Nevertheless, special burdens should not be placed on

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234. *See* Rinaldi, *supra* note 21, at 98.

235. *Id.*; *see* Bd. of Supervisors of Fairfax County v. Snell Constr. Corp., 202 S.E.2d 889, 892 (Va. 1974) (asserting that landowners will only invest in a project when the prospect of profit is reasonably certain, which is complicated without vesting laws that assure project completion).

236. Ben-Joseph, *supra* note 5, at 9.

237. Frank I. Michelman, *Property, Utility, and Fairness: Comments on the Ethical Foundations of "Just Compensation" Law*, 80 HARV. L. REV. 1165, 1172 (1967).

238. Laura S. Underkuffler, Tahoe*'s Requiem: The Death of the Scalian View of Property and Justice,* 21 CONST. COMMENT. (forthcoming 2005) (unpublished article at 27, on file with Duke University School of Law), *available at* http://lsr.nellco.org/duke/fs/papers/22/.

identifiable individuals in order to confer benefits upon the majority,[239] and this notion persists throughout Part IV of this Note. The solution follows a totality of the circumstances ad hoc approach, which seems to be in line with recent Supreme Court takings jurisprudence.[240] Takings is an area closely related to vested rights and recent analysis reveals that significant individual loss to a landowner will not necessarily lead to the conclusion that a wrong has occurred.[241] This indicates the government may be able to retain a great deal of power in deciding if a right has vested. Thus, a balanced and comprehensive approach is all the more necessary.

### *A. Type of Structure*

The first factor used to determine which vesting rule to apply is the type of structure being built. If the developer is constructing a building, this would favor the "early vesting" rule. It is of the utmost importance to protect investment in buildings if society is going to continue to have shelter for residential, commercial, and industrial purposes.[242] Buildings differ from raw land because raw land obtains value from its location and proximity to other activities.[243] Investment in raw land is not very important as a matter of efficiency.[244] On the other hand, structural buildings are driven by the demands of the people who live, work, and shop in the community.[245] The demands and needs of the community cannot be met if a developer faces a great deal of uncertainty because of the possible intrusion of zoning law into a project that is in the midst of construction.[246]

Uncertainty (in terms of project completion and realization of return on investment) surrounding the construction of buildings can lead to increased purchase prices because of holding costs, overhead, increased costs of labor, and great expenditures for materials.[247] In fact, one study indicates that for every additional month added to the expected completion date of a home, there is a one to two percent increase in the selling price of the home to a consumer.[248] The same study also indicated that over the past twenty-five years there has been a

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239. FISCHEL, *supra* note 10, at 151; *see* Michelman, *supra* note 237, at 1166.

240. *See* Underkuffler, *supra* note 238, at 2, 9 (explaining that the Supreme Court has returned to an ad hoc analysis for regulatory takings where the subject land is not completely deprived of all value and where all relevant circumstances are weighed).

241. *See id.*

242. Hagman, *supra* note 23, at 529 (noting that it is not as important to encourage investment in raw land because it will continue to exist, unlike buildings).

243. *Id.*

244. *Id.*

245. FISCHEL, *supra* note 10, at 56.

246. *Id.*

247. *See* ROBERT H. FREILICH & ERIC O. STUHLER, THE LAND USE AWAKENING, 179 (1981); Ben-Joseph, *supra* note 5, at 15, 17.

248. Ben-Joseph, *supra* note 5, at 15.

steady increase in the time needed to receive subdivision approval.[249] The average time for approval of a subdivision in 2002 was seventeen months, a significant amount of time during which any number of contingencies could thwart a development project.[250] Some of the costs and risks associated with regulation and compliance thus has undoubtedly shifted to the purchaser because of the lengthened approval process.[251]

Thus, a consideration of the purpose of the project in providing a home, locus of commerce, or industry which offers employment should factor into which vesting rule should apply. It seems highly probable that in most instances the end product of a large, investment-intensive project will be a building. Thus, the developer of a building will find this factor weighs in favor of the application of an "early vesting" standard.

### *B. Number of Permits*

The second factor is the number of permits required to complete a project. It seems more equitable to apply a "late vesting" rule to projects requiring fewer permit approvals. Beginning in the 1950s, complicated land use control systems came into existence and made it more difficult for developers to acquire vested rights, particularly in majority rule jurisdictions.[252] Frustration is the typical reaction developers experience because of the increased regulation.[253] Illustrative of the frustration is the Urban Land Institute's statement that "American developers . . . must deal with an expanding array of regulations at every level of government . . . [which] inevitably inflate[s] [the] paperwork required for a project and intensif[ies] the complexity of data, analysis, and review procedures for both the public and private sector."[254]

The emergence of various agencies involved in the development process has increased the number of permits needed, the cost of permitting, and the time needed to receive permit approval.[255] A greater number of permit approvals requires a greater initial investment. Therefore, larger projects are subject to a higher risk of lost investment if no vested right is acquired. To use Indiana as an example, a planned subdivision of fifty units in a middle class Indianapolis neighborhood would require an initial investment of $203,300.[256] If a developer believed there was a good chance such a large investment could be lost because

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249. *Id.*

250. *Id.*

251. *Id.*

252. *See* Hanes & Minchew, *supra* note 15, at 388 (noting that prior to World War II only one government approval was needed for landowners).

253. Ben-Joseph, *supra* note 5, at 17.

254. *Id.*

255. *Id.* at 19.

256. Telephone Interview with Shannon Hinshaw, Development Coordinator, Centex Homes, in Indianapolis, IN. (Jan. 10, 2005); Permit Schedule of Fees from Shannon Hinshaw, Development Coordinator, Centex Homes, to the staff of Centex Homes 1 (Jan. 10, 2005) (on file with author).

of future development regulations, it is easy to see how construction of new buildings would be chilled.

Furthermore, the permitting process is burdensome and complicated. There are at least 321 federal regulations affecting the building process.[257] In discussing permits, Professor Hagman used the analogy of a developer driving on a race course with the finish line being the acquisition of vested rights.[258] He reasoned that the more "stop lights" (permits) the "driver" (developer) must pass through, the less likely that the driver will be successful in acquiring a vested right.[259] Furthermore, even if the race course is completed, rights may still not vest in some states if substantial construction or investment has not been undertaken.[260]

However, the fewer stoplights the driver must pass through, the more diligent and timely the investment and construction of the project should be. On a course with only a few stoplights (a small scale development), it is likely that no great investment is needed to reach the finish line.[261] Thus, a "late vesting" rule appears to be fair in situations where only a few permits are required because the level of uncertainty is diminished in comparison to a large project.[262] "If only one, easily obtained permit is required, it makes sense to require that the permit first be issued and that substantial construction or liabilities be incurred before a right to complete development vests."[263] Thus, the number of permits needed to begin construction as well as the pervasiveness of the government requirements in order to apply for and obtain the permit should be taken into consideration to determine which vesting rule will control.

### *C. Investment by the Developer in the Project*

The third factor which is relevant to the court's decision on which vesting rule to apply is the developer's investment in the project. Overall cost and investment toward completion of a project is a necessary and pertinent consideration that is already found in the proportionate/ratio test.[264] A greater investment toward the overall cost of the project would favor the application of an "early vesting" rule because of the potential for inflicting harsh results on the developer. For example, the average cost of constructing a home in Indianapolis, Indiana, is $188,659.[265] A subdivision developer would stand to lose a great deal of money when planning for multiple units. Because of the large investment, the potential for demoralization costs will be greater for developers of sizable

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257. Ben-Joseph, *supra* note 5, at 8.
258. Hagman, *supra* note 23, at 538.
259. *Id.*
260. *Id.*
261. *Id.*
262. *Id.*
263. *Id.* at 529.
264. *See, e.g.*, Clackamas County v. Holmes, 508 P.2d 190, 209 (Or. 1973).
265. MIBOR, *supra* note 9, at 2.

projects, especially when construction has already begun.[266] Demoralization costs are the amount needed to offset the disadvantages suffered by the developer plus the present value of loss to the affected developer, those similarly situated, and sympathizers.[267] Demoralization costs result from the redistribution of rights to property causing expectations of developers and landowners to be disappointed.[268] High demoralization costs are more devastating for developers undertaking long term projects and may discourage future development.[269]

On the other hand, a minimal degree of protection for projects that are less investment-intensive is not a new concept in the law. *Cheney Brothers v. Doris Silk Corp.*[270] and *Smith v. Chanel, Inc.*[271] illustrate that where investment into an asset is not substantial, powerful property rights will not arise to protect those assets. In *Cheney Brothers*, a corporation involved in the design of dresses was denied a copyright for dress patterns.[272] In *Smith*, the court held a perfume company could advertise its product as the equivalent of Chanel, Inc.'s perfume.[273] Although dress designs and perfume may not receive the protections arising from the law of property, long term endeavors which concentrate more investment, like pharmaceuticals, receive strong protection in the law.[274] Thus, an examination of the total investment compared to the overall estimated cost, in order to discover the intensity of investment, is a factor to be considered.

However, not only should the current investment as compared to the overall cost of the project be considered, but the quantitative expenditure should be examined as well.[275] The proportionate/ratio test is best suited for application to smaller projects because if a large investment or important part of the project has been completed the test will validate the project.[276] Conversely, a "nominal investment" test is best suited for large projects because even a substantial investment into a costly project may not have a favorable outcome under the proportionate/ratio test.[277] A "nominal investment" test would examine the size of the sum expended absent any comparison with the total cost of the project. If the sum expended on the project was large enough, the project would be

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266. Hagman, *supra* note 23, at 528.

267. Michelman, *supra* note 238, at 1214.

268. *Id.* at 1212.

269. *Id.*; *see also* Hagman, *supra* note 23, at 528.

270. 35 F.2d 279 (2d Cir. 1929).

271. 402 F.2d 562 (9th Cir. 1968).

272. *Cheney Bros.*, 35 F.2d at 280.

273. *Smith*, 402 F.2d at 569.

274. Leah R. Garnett, *Prozac Revisited*, BOSTON GLOBE, May 7, 2000, at A1, *available at* http://www.drugawareness.org/Archives/1stQtr_2001/050700Prozac.html (discussing the expiration of Eli Lilly & Co.'s fourteen-year patent on its drug Prozac).

275. Cooper v. County of Los Angeles, 138 Cal. Rptr. 229, 233 (1977) (recognizing that a proportionate/ratio test is conducive to a small project while a quantitative test lends itself to a larger project).

276. *Id.*

277. *Id.*

validated. Also, the investment factor would favor an "early vesting" standard.[278] The problem in attempting to measure investment is deciding what constitutes a small project and what constitutes a large project. Thus, in order to assure thorough judicial scrutiny and prevent any failure to recognize the type of development project being undertaken, both tests should be employed and examined.

### *D. Social Utility of the Proposed Development and Best and Highest Use*

Finally, courts should consider a fourth factor, the social value of the development at issue. Social utility and the best and highest use of the land become relevant factors because of the undesirable nature of the billboard in the *Pinnacle Media, LLC* case. This factor includes a consideration of how the proposed land will impact the public as compared to the harm the landowner will suffer if development rights are denied.[279] A "late vesting" rule seems especially fit for a small project with arguably little social utility, such as a billboard. On the other hand, a home has arguably high social utility and so an "early vesting" standard seems justified. The "late vesting" rule allows the public and elected government officials the greatest opportunity to voice any concern over the development.[280] Only after the small, low utility project had commenced construction or reached a point of substantial reliance or investment could the developer continue without interference from the government. In this way, the developer has given the public and government every opportunity to prevent a use it may view as undesirable.

In order to prevent this factor from becoming too subjective and unpredictable, a standard of "reasonable expectations" based on social norms must control.[281] "If a parcel of land were uniquely suited for some activity deemed subnormal or unneighborly, the social norm rule would allow a valid zoning ordinance" to prevent the owner from developing as planned.[282] The social norms of a community can be found by examining the past behavior of the community.[283] The use of a standard of "normal" behavior in the community for determining the best and highest use of a parcel protects the landowner from the imposition of "supernormal" regulations and at the same time allows the community to avoid "subnormal" uses from entering into the area.[284] Therefore, although the social utility factor initially appears regulator friendly, it could certainly weigh in favor of the "early vesting" rule and benefit the landowner.

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278. *See id.*

279. Nott v. Wolff, 163 N.E.2d 809, 813 (Ill. 1960).

280. *See* Hagman, *supra* note 23, at 530; *see also* Underkuffler, *supra* note 238, at 7 (noting that recent Supreme Court decisions imply that the public interest can trump a property owner's complaint concerning burdensome regulations).

281. *See* FISCHEL, *supra* note 10, at 159.

282. *Id.*

283. *Id.*

284. *Id.*

For instance, in *Pinnacle Media*, the proposed billboard was at least one of the highest and best uses for which a railroad corridor could be used and would likely not be considered "subnormal" when placed next to an interstate.

## CONCLUSION

Society's need for homes, offices, and industrial buildings will only continue to grow as the population increases. Developers need to be certain that a project will not be subject to a newly enacted ordinance at some point in the future. The doctrine of vested rights is supposed to provide that certainty. However, if uncertainty surrounds vested rights to develop, land developers will be hesitant to continue investing in projects. Certainly, in a state like Indiana, the development process is unnecessarily ambiguous because two vesting standards exist. One rule, the "late vesting" rule, vests development rights only after actual construction has begun. The other rule, the "early vesting" rule, vests rights when a permit is filed which is in compliance with existing ordinances. However, the two rules can continue to exist in a more efficient and equitable system of vested rights. The "late vesting" rule existed and was effective in the past when single buildings were the norm in development. Thus, it is better suited for less investment-intensive and time consuming projects. The "early vesting" rule developed in conjunction with the proliferation of subdivisions. Therefore, it is conducive to large, investment-heavy projects that may take years to complete.

Under a bifurcated approach, where the initial inquiry examines a number of factors to determine which rule should be applied, equity in vesting can be more consistently achieved. A consideration of the type of structure being built, the number of permits needed to construct the building, the investment made by the developer, and the social utility of the project will allow for the correct vesting rule to be applied more consistently. Under this approach, a developer may insulate a project from a newly enacted ordinance in two ways. A developer may either meet the factors that lead to application of an "early vesting" rule or begin actual construction. However, the approach still allows the government flexibility to meet public needs by retaining the "late vesting" rule.

The bifurcated approach recognizes that acquisition of vested rights turns on the circumstances of a development. The emergence of various vesting rules illustrates that different circumstances call for different rules. The bifurcated approach allows for a comprehensive review of relevant factors. The bifurcated approach makes it more likely that the correct vesting standard will be applied. In turn, this will yield more equitable results and developers will not fear loss of investment. Thus, the need for continued development will be met because the amount of uncertainty will decrease.

# TAKING BACK EMINENT DOMAIN: USING HEIGHTENED SCRUTINY TO STOP EMINENT DOMAIN ABUSE

MICHAEL A. LANG*

## INTRODUCTION

Suppose you live in a small town that has struggled economically for decades. You live in a nice house that you adore and you do not want to move from it. You also own a small business located just around the corner from your house. A white knight has come to save your town's struggling economy in the form of a large company that will build a factory in your city. The company says it will create about one thousand jobs, which will fill the town's coffers with tax revenue. The deal sounds great until you hear the catch: the company will not build its plant if it cannot build in a certain location—your neighborhood. You do not want to sell your property for any price. Then the city sends you a notice stating that your property is to be condemned. Finally, you seek your lawyer's advice and ask if there is anything you can do to stop the eminent domain action. After all, the city cannot really take your property and give it to a private business, can they? Unfortunately, there is no clear answer.

The Fifth Amendment's Takings Clause states, "nor shall private property be taken for public use, without just compensation."[1] Some jurisdictions have determined that condemning one person's property to transfer it to another private entity satisfies the public use requirement. These jurisdictions state that "economic development" that creates jobs, increases the state's or community's tax base, or expands industry can be a valid public use. Thus, these jurisdictions have determined that what many people would consider to be a private use actually constitutes a public use.

Although the U.S. Supreme Court has long held that "a law that takes property from A, and gives it to B would be contrary to the great first principles of the social compact and cannot be considered a rightful exercise of legislative authority,"[2] the debate over what constitutes a public use has been raging since the middle of the nineteenth century.[3] By the early 1980s the debate seemed to be resolved. In 1981, the Supreme Court of Michigan handed down its infamous decision, *Poletown Neighborhood Council v. City of Detroit*,[4] which allowed an

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* J.D. Candidate, 2006, Indiana University School of Law—Indianapolis; B.A., *cum laude*, 2003, Ball State University, Muncie, Indiana. The author would like to thank Megan Mulford for her insightful comments regarding the substance and structure and the members of the Indiana Law Review who edited this Note. The author also thanks his mother, Anna M. Lang, M.A., for her assistance with grammar and style issues.

1. U.S. CONST. amend. V.

2. James W. Ely, Jr., *Can the "Despotic Power" Be Tamed?*, 17 PROB. & PROP. 31, 32 (2003) (internal quotation marks omitted) (citing Calder v. Bull, 3 U.S. (3 Dall.) 386, 388 (1798) (seriatim opinion of Chase, J.)).

3. *See id.* at 33.

4. 304 N.W.2d 455 (Mich. 1981) (per curiam), *overruled by* County of Wayne v. Hathcock,

entire residential neighborhood to be condemned and subsequently transferred to General Motors so it could build a new assembly plant.[5] In 1984, in *Hawaii Housing Authority v. Midkiff*,[6] the United States Supreme Court implicitly resolved the question of whether the Takings Clause's Public Use Clause allows economic development to be a public use. *Midkiff* held that a legislature's determination that a taking constitutes a public use should receive the greatest degree of judicial deference.[7] Despite these rulings, the debate rages on. Courts in several jurisdictions have begun to reign in the legislature,[8] and at least one federal case has distinguished itself from *Midkiff*.[9] Also, in 2004, the Supreme Court of Michigan explicitly overruled *Poletown*,[10] and the U.S. Supreme Court affirmed a Connecticut case that fully embraced the reasoning of both *Poletown* and *Midkiff* when it interpreted federal and state constitutional issues.[11] In 2005, the U.S. Supreme Court handed down its controversial decision, *Kelo v. City of New London* (*Kelo II*).[12] In addition to the Public Use Clause, forty-nine state constitutions contain similar clauses,[13] which state courts may interpret differently than the Fifth Amendment of the U.S. Constitution.

With this ongoing debate in mind, this Note argues for a much narrower definition of what constitutes a "public use" and contends that courts should analyze problematic takings cases with heightened scrutiny. Part II examines the public use requirement and how the Supreme Court has interpreted the Fifth Amendment's Taking Clause as well as how state courts have interpreted analogous state clauses. Part III discusses problems associated with cases that give broad meaning to the public use requirement. Part IV addresses why newer cases that use a narrow meaning of public use have nonetheless not gone far

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684 N.W.2d 765 (Mich. 2004).

5. *Id.*; *see also* Stephen J. Jones, Note, *Trumping Eminent Domain Law: An Argument for Strict Scrutiny Analysis Under the Public Use Requirement of the Fifth Amendment*, 50 SYRACUSE L. REV. 285, 295 (2000).

6. 467 U.S. 229 (1984).

7. *See id.* at 241.

8. *See, e.g.*, Sw. Ill. Dev. Auth. v. Nat'l City Envtl., L.L.C., 768 N.E.2d 1 (Ill. 2002); Ga. Dep't of Transp. v. Jasper County, 586 S.E.2d 853 (S.C. 2003).

9. *See* 99 Cents Only Stores v. Lancaster Redev. Agency, 237 F. Supp. 2d 1123, 1129 (C.D. Cal. 2001), *appeal dismissed as moot*, 60 Fed. Appx. 123 (9th Cir. 2003).

10. County of Wayne v. Hathcock, 684 N.W.2d 765, 787 (Mich. 2004).

11. Kelo v. City of New London (*Kelo I*), 843 A.2d 500, 528 (Conn. 2004), *aff'd*, 125 S. Ct. 2655, *reh'g denied*, 126 S. Ct. 24 (2005).

12. Kelo v. City of New London (*Kelo II*), 125 S. Ct. 2655, *reh'g denied*, 126 S. Ct. 24 (2005).

13. Dana Berliner, *Public Use, Private Use—Does Anyone Know the Difference?*, SJ052 ALI-ABA 789, 791 (2004); *see also* ILL. CONST. art. I, § 15 ("Private property shall not be taken or damaged for public use without just compensation as provided by law."); MICH. CONST. art. X, § 2 ("Private property shall not be taken for public use without just compensation therefor being first made or secured in a manner prescribed by law."). Indiana does not have a public use clause. *See* IND. CONST. art. I, § 21.

enough. Part V proposes a solution that, if adopted, would require courts to apply heightened scrutiny to problematic public use cases. Finally, this Note concludes with a call for political action, including constitutional amendment, by the public and legislatures to narrow the scope of "public use."

## II. THE PUBLIC USE REQUIREMENT AND ITS INTERPRETATION BY FEDERAL AND STATE COURTS

### *A. Federal Court Interpretation of the Public Use Requirement*

*1. Supreme Court Interpretation of the Public Use Requirement.*—The Supreme Court has clearly held for over fifty years that the Fifth Amendment's Public Use Clause does not necessarily prevent the government from taking real property from one private individual and transferring it to another.[14] Also, for over twenty years, the Court has held that states possess the same power.[15] The Court has determined that the rational basis test is the proper standard to analyze the constitutionality of a taking.[16]

In *Berman v. Parker*,[17] the Court held that Congress has the power to transfer private land to another private entity to accomplish its urban renewal goals.[18] Congress allowed an agency of the District of Columbia to take property to remove blighted areas and slums from Washington, D.C. A planning commission determined that the area encompassing the appellants' department store was blighted and sought to take the land through eminent domain. The agency planned to subsequently transfer the land to other public and private entities.[19] The department store, although located in a blighted area, was not part of the slum.[20] The Court rejected the argument that the taking primarily benefited the private entity that received the land post-condemnation because the Court determined that Congress had acted within the scope of its police powers over the District of Columbia and in such a case the trial court's role "is an extremely narrow one."[21] The Court also held that Congress could authorize the transfer of sanitary and non-blighted land to private individuals because the goal of the project was to ensure that blight and slums did not reappear.[22] Thus, *Berman* represents an extremely broad interpretation of the Public Use Clause. As *Midkiff* noted thirty years later, this interpretation is "coterminous with the scope

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14. Berman v. Parker, 348 U.S. 26, 33-34 (1954).

15. *See* Haw. Hous. Auth. v. Midkiff, 467 U.S. 229, 240-41 (1984).

16. Ralph Nader & Alan Hirsch, *Making Eminent Domain Law Humane*, 49 VILL. L. REV. 207, 211-12 (2004) (quoting *Midkiff*, 467 U.S. at 241).

17. 348 U.S. 26 (1954).

18. *See id.* at 33-34.

19. *Id.* at 29-31.

20. *Id.* at 30.

21. *Id.* at 32.

22. *Id.* at 34.

of a sovereign's police powers."[23] Indeed, the Court's reading of the Public Use Clause is so broad that it led the Court to state that the legislature, and not the courts, "is the main guardian of the public needs" in eminent domain cases.[24]

The Court further expanded its definition of public use in *Midkiff*. In *Hawaii Housing Authority v. Midkiff*, Hawaii condemned the fee simple title to certain land and sold the title to the private entity leasing the land. The State did this because almost all of Hawaii's privately owned land was owned by seventy-two landowners, thus altering the fee simple market.[25] The Court gave maximum deference to the legislature's determination of what the public use at issue was and held that a taking is constitutional if it is rationally related to a legitimate state interest.[26] To apply a greater level of scrutiny to takings, the Court thought, would put courts in the precarious position of determining what is and is not a governmental function, which the Court had found "impracticable in other fields."[27] Indeed, to the *Midkiff* Court, eminent domain is but a means to accomplishing a legislative end, that is, a public use.[28] Because the legislature rationally provided for the condemnation of the land to further the legitimate goal of decreasing an oligopoly, the statute met constitutional muster.[29] *Midkiff* also provided for a wide reading of the Public Use Clause by not requiring that the public at large, or even a large part of it, benefit from the taking.[30]

The U.S. Supreme Court expanded its interpretation of the Public Use Clause in *Kelo II*. In *Kelo II*, the plaintiffs' homes were condemned to make room for a research park designed to complement a Pfizer facility that had just opened in New London, Connecticut. New London touted the research park as a means to create over one thousand new jobs, increase tax revenue, and revitalize the city's downtown.[31] The petitioners' property, which included homes that were not blighted, were to be condemned to make way for "research and development office space," retail shops, and parking, depending on the location of the property.[32]

In an opinion by Justice Stevens, the Court held that the takings served a valid public purpose, and as such were constitutional, because the takings were part of a "carefully formulated economic development plan" that the city believed would "provide appreciable benefits to the community."[33] In arriving

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23. Haw. Hous. Auth. v. Midkiff, 467 U.S. 229, 240 (1984).

24. *Berman*, 348 U.S. at 32.

25. *Midkiff*, 467 U.S. at 232-34.

26. *Id.* at 242-43.

27. *Id.* at 241 (quoting United States *ex rel.* Tenn. Valley Auth. v. Welch, 327 U.S. 546, 552 (1946)).

28. *Id.* at 240 (quoting *Berman*, 348 U.S. at 33).

29. *Id.* at 242.

30. *Id.* at 244 (quoting Rindge Co. v. L.A. County, 262 U.S. 700, 707 (1923)).

31. Kelo v. City of New London (*Kelo II*), 125 S. Ct. 2655, 2659, *reh'g denied*, 126 S. Ct. 24 (2005).

32. *Id.* at 2659-60.

33. *Id.* at 2665.

at this result, the court rejected any distinction between the terms "public use" and "public purpose."[34] Also, after citing *Berman*, *Midkiff*, and other cases extensively, the Court noted that its holding was necessary to give state courts and legislatures the "great respect" that they were owed as the institutions that respond to the varied and evolving needs of society.[35] Additionally, the Court stated that it reviewed state action in a case like this to ensure that the state's end was legitimate and "its means are not irrational."[36]

The Court further rejected a bright-line rule that would have provided that economic development could not be considered a public use or, in the alternative, that the condemning authority had to prove that the benefits it asserted would likely be achieved by the project for which eminent domain is used.[37] The Court held that the better approach is to review the condemning authority's plan in its entirety, and not on an individual basis, and to determine if the condemning authority has a comprehensive plan and that it "thorough[ly] deliberat[ed]" the plan prior to its adoption.[38] The Court did note that this rule was not intended to provide a condemning authority with *carte blanche* to condemn as it pleased. The Court stated that a taking occurring outside an "integrated development plan" may indicate that condemning authority was taking the property for purely private reasons.[39] Thus, *Kelo II* serves to solidify the Court's Takings Clause jurisprudence and likely will be used to justify the constitutionality of the vast majority of takings.

*Berman*, *Midkiff*, and *Kelo II* represent the broadest interpretations of "public use."[40] Although the Court has acknowledged a narrow role for courts reviewing eminent domain actions,[41] it is quite difficult, absent explicit and complete deference to the legislature, to find a broader interpretation of the Public Use Clause. In addition, *Berman*, *Midkiff*, and *Kelo II* represented a sea change in takings law. No longer is it impermissible to "take land from A and give it to B."[42]

This extremely broad interpretation has led inexorably to the inability of the

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34. *See id.* at 2663-64.

35. *Id.* at 2664 (internal quotation marks omitted) (quoting Hairston v. Danville & W. Ry. Co., 208 U.S. 598, 606-07 (1908)).

36. *Id.* at 2667 (internal quotation marks omitted) (quoting Haw. Hous. Auth. v. Midkiff, 467 U.S. 229, 242 (1984)); *see also id.* at 2269 (Kennedy, J., concurring) (noting that the standard of review under *Berman* and *Midkiff* is similar to the "rational-basis test used to review economic regulation under the Due Process and Equal Protection Clauses").

37. *Id.* at 2666-67 (majority opinion).

38. *Id.* at 2665.

39. *Id.* at 2667.

40. *See* Ely, *supra* note 2, at 34.

41. *Midkiff*, 467 U.S. at 240.

42. Derek Werner, Note, *The Public Use Clause, Common Sense and Takings*, 10 B.U. PUB. INT. L.J. 335, 344-45 (2001); *see also* Calder v. Bull, 3 U.S. (3 Dall.) 386, 388 (1798) (seriatim opinion of Chase, J.).

Public Use Clause to protect individual property rights.[43] Because the Court has opted to give takings cases almost the lowest level of scrutiny, and by placing the definition of "public use" within the ambit of the police power, the requirement does not limit a government's eminent domain power because the legislative body can generally always find *some* public purpose to justify a taking.[44] Indeed, when the legislature has almost exclusive control of defining what constitutes a public use, it could hardly run afoul of the Public Use Clause. Thus, absent an external limitation on the taking, such as a violation of the Equal Protection Clause of the Fourteenth Amendment, a court likely will not find the taking to be barred by the Constitution. Therefore, the Public Use Clause, in most cases, will not entitle one to a legal remedy for the wrongful taking of his land; it confines the former owner to a political remedy,[45] such as taking his grievances to the polls in the next election.

2. *Recent Lower Federal Court Interpretations of the Public Use Requirement.*—Although the Supreme Court has interpreted the Public Use Clause broadly, several lower federal courts have found some takings limited by the clause. Indeed, these courts found ways around the strict deference to the legislature that *Berman*, *Midkiff*, and *Kelo II* demanded.[46] These cases did not follow the traditional rational basis review rules, which require a court to find for the government if the asserted public use is merely conceivable.[47] In these cases, the court was not satisfied with the government's proffered public use and required the government to show that the asserted use or benefit could be achieved.[48] In one case, *Daniels v. Area Plan Commission of Allen County*,[49] the court of appeals held that an asserted public use that was "conclusory and largely unsupported" would not meet the Public Use Clause.[50]

One particular case has distinguished itself from the Supreme Court cases. In *99 Cents Only Stores v. Lancaster Redevelopment Agency*,[51] the Lancaster Redevelopment Agency ("Agency") sought to condemn the leasehold interest of

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43. This is hardly a new or novel concept. Over fifty years ago it was recognized that Congress and state governments failed to see the Public Use Clause as a limitation upon the government. Nader & Hirsch, *supra* note 16, at 209 (relying upon Comment, *The Public Use Limitation on Eminent Domain: An Advance Requiem*, 58 YALE L.J. 599, 614 (1949)).

44. *See id.* at 212; *see also* Kelo v. City of New London (*Kelo II*), 125 S. Ct. 2655, 2676-77, *reh'g denied*, 126 S. Ct. 24 (2005) (O'Connor, J., dissenting).

45. For examples of political remedies, see Berliner, *supra* note 13, at 798-800 (noting, inter alia, that public pressure forced developers to give up plans to demolish one-fifth of Pittsburgh's downtown).

46. *See* Nicole Stelle Garnett, *The Public Use Question as a Takings Problem*, 71 GEO. WASH. L. REV. 934, 936 (2003).

47. *Id.* at 935-36.

48. *Id.*

49. 306 F.3d 445 (7th Cir. 2002).

50. *Id.* at 463-64; Garnett, *supra* note 46, at 934.

51. 237 F. Supp. 2d 1123 (C.D. Cal. 2001), *appeal dismissed as moot*, 60 Fed. Appx. 123 (9th Cir. 2003).

99 Cents Only Stores ("99 Cents") in a shopping center location.[52] The Agency sought condemnation to meet Costco's demands for expansion of its local store and to prevent Costco from relocating. When 99 Cents refused to sell its interest, the Agency attempted to condemn the land so it could sell it to Costco for one dollar.[53] The Agency attempted to assert as a public use the prevention of future blight that could be caused if Costco relocated.[54] The court distinguished this case from *Midkiff* by fitting its decision into the narrow role that *Midkiff* carved out for judicial review.[55] The court held that because the Agency admitted that it was only trying to appease Costco and because the goals of Costco could have been met without interfering with 99 Cents's leasehold interest, the eminent domain action would fail.[56] Also important to the *99 Cents Only Stores* court was that the Agency had not made any findings that future blight could occur, and thus did not tie the taking to these findings; the Agency merely stated the rationale once it was in court.[57] Thus, the *99 Cents Only Stores* court was unwilling to find a valid public purpose where there was no factually supported legislative determination that a public purpose would be served by the taking.[58]

Thus, some lower federal courts may be willing to use heightened level of scrutiny when the condemning authority has not set forth any findings to establish a public use. However, in light of these cases, future takings could be justified with public uses that are established beforehand by findings that are general enough to be upheld under the *Berman* and *Midkiff* standards. For example, if the Agency in *99 Cents Only Stores* had set forth findings ex ante, whether grounded in reality or not, that the taking would create $x$ jobs and generate $y$ tax dollars, it is more likely that a court would uphold the taking, even though the taking only benefited Costco.

### *B. Interpretation of Public Use Requirements in State Constitutions*

Although most state constitutions include public use requirements, only about half of those jurisdictions have ever ruled on whether economic development qualifies as a public use.[59] Currently, approximately half of the states that have decided the issue have allowed transfers to private entities for the purpose of economic redevelopment, and half have not.[60] Thus, there are two basic rules from which the remaining states may choose.

*1. Courts Using a Broad Interpretation of Their State's Public Use Requirement.*—Many state courts have interpreted their state's public use

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52. *Id.* at 1126.
53. *Id.*
54. *Id.* at 1129.
55. *Id.* (quoting Haw. Hous. Auth. v. Midkiff, 467 U.S. 229, 240 (1984)).
56. *Id.*
57. *Id.* at 1130.
58. *Id.*
59. Berliner, *supra* note 13, at 794.
60. *Id.*

requirements as the Supreme Court interpreted the Fifth Amendment in *Berman*, *Midkiff*, and *Kelo II*. These states also allow for maximum deference to the legislature. These cases are a liberal variant of the public-benefit theory, which holds that a taking is permissible if it furthers a permissible legislative end.[61]

The broad interpretation of state public use requirements is best exemplified by *Poletown Neighborhood Council v. City of Detroit*.[62] Although overruled in 2004,[63] *Poletown* remains important because it has been repeatedly cited by courts outside of Michigan.[64] In *Poletown*, Detroit attempted to condemn its Poletown neighborhood so that General Motors could build an assembly plant at that location.[65] General Motors had threatened to remove approximately six thousand jobs from Detroit if it was not allowed to build on the Poletown site. Additionally, General Motors made several demands regarding the condition of the site and paid a price significantly lower than market value for the site.[66]

The *Poletown* court began its analysis by explicitly disavowing any distinction between "public use" and "public purpose."[67] Once the court extinguished that distinction, the court easily determined that in light of the state's police powers, Michigan could use eminent domain to reduce unemployment and its effects on society.[68] The court further held that although a taking for a private purpose would violate the state's public use requirement, the government can condemn the land and transfer it to a private entity when a private use is incidental to the public purpose.[69] In many ways, the *Poletown* court's conclusions became the jurisprudential model upon which *Midkiff* would be based three years later.[70] Indeed, in another parallel to *Midkiff*, the *Poletown* court gave extreme deference to the legislature, citing *Berman* approvingly and stating that after the public use is determined, the court has only a limited role in reviewing it.[71] Thus, *Poletown*'s brief per curiam opinion became the quintessential case that justified an expansive interpretation of the Public Use Clause.

Other states have followed the reasoning of cases like *Poletown*, *Berman*,

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61. Thomas J. Posey, Note, *This Land is My Land: The Need for a Feasibility Test in Evaluation of Takings for Public Necessity*, 78 CHI.-KENT L. REV. 1403, 1407 (2003). The public-benefit theory is in contrast to the actual-use theory which holds that all members of the public must have access to and enjoy the actual use of the land. *Id.*

62. 304 N.W.2d 455 (Mich. 1981) (per curiam), *overruled by* County of Wayne v. Hathcock, 684 N.W.2d 765 (Mich. 2004).

63. *Hathcock*, 684 N.W.2d at 787.

64. *E.g.*, Kelo v. City of New London (*Kelo I*), 843 A.2d 500 (Conn. 2004), *aff'd*, 125 S. Ct. 2655, *reh'g denied*, 126 S. Ct. 24 (2005).

65. *Poletown Neighborhood Council*, 304 N.W.2d at 457.

66. *Id.* at 467-70 (Ryan, J., dissenting).

67. *Id.* at 457 (majority opinion).

68. *Id.* at 458; *see also Hathcock*, 684 N.W.2d at 784-85.

69. *Poletown Neighborhood Council*, 304 N.W.2d at 458.

70. *See* Nader & Hirsch, *supra* note 16, at 218.

71. *Poletown Neighborhood Council*, 304 N.W.2d at 458-59.

and *Midkiff*. Most recently, in *Kelo v. City of New London* (*Kelo I*), the Supreme Court of Connecticut simultaneously accepted the reasoning of *Poletown* and applied *Midkiff*'s rational basis test.[72] The *Kelo I* court based its decision not only on the federal grounds that were affirmed by the U.S. Supreme Court in *Kelo II*, but also on open state constitutional grounds. In so holding, the *Kelo I* court determined, in light of the deference owed the legislature, that economic development is a valid public purpose, similar to slum clearance.[73] In addition, the *Kelo I* court, like the *Poletown* court, rejected the argument that transferring the land to private parties for economic development primarily benefited the private entities.[74] The court reasoned that because New London's goal was economic redevelopment, private entities and transfers of this type *had* to be involved.[75] Additionally, the court more clearly articulated the standard of review that a court should use in these types of cases. The court determined that courts are to look at whether the taking primarily benefits the public or a private entity.[76] However, despite this judicial role, the *Kelo I* court left the issue to the trier of fact, and thus reviewed the issue under the "clearly erroneous" standard.[77] Perhaps this formulation is a clear articulation of the judicial role the *Berman* and *Midkiff* Courts provided.[78]

Several other states have read their public use clauses broadly and approved takings similar to those in *Berman*, *Poletown*, and *Kelo I*. The Supreme Court of Kansas approved the taking of two businesses for the creation of an industrial park that would be held by private owners after the court determined that economic development is a legitimate public use.[79] In *City of Duluth v. State*,[80] the Supreme Court of Minnesota gave Minnesota's public use clause an even broader interpretation than those used in *Poletown* and *Kelo I*.[81] The *Duluth* court held that if the trial court can marshal *any* evidence to support a finding of public purpose, then the court must uphold the taking unless to do so would be "manifestly arbitrary or unreasonable."[82] These additional cases demonstrate that jurisdictions adopting the broader interpretation of "public use" use more or less the same deferential rational basis review. Absent arbitrariness and abuse, courts

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72. 843 A.2d 500, 528 (Conn. 2004), *aff'd*, 125 S. Ct. 2655, *reh'g denied*, 126 S. Ct. 24 (2005).

73. *Id.* at 532.

74. *Id.* at 536-37.

75. *See id.*

76. *See id.* at 541.

77. *See id.*

78. *See supra* notes 24, 42 and accompanying text.

79. Gen. Bldg. Contractors, L.L.C. v. Bd. of Shawnee County Comm'rs, 66 P.3d 873, 882-83 (Kan. 2003).

80. 390 N.W.2d 757 (Minn. 1986).

81. *See id.* at 763; *see also* Jennifer J. Kruckeberg, Note, *Can the Government Buy Everything?: The Takings Clause and the Erosion of the "Public Use" Requirement*, 87 MINN. L. REV. 543, 556 (2002).

82. *Duluth*, 390 N.W.2d at 763.

in these jurisdictions will validate the legislature's determination of what constitutes a public use.

*2. Courts Using a Narrow Interpretation of Their State's Public Use Requirement.*—Some jurisdictions read their respective public use clauses more narrowly than their aforementioned counterparts. These jurisdictions tend not to view economic development as a public use, or at least give the legislature less deference when deciding if the primary beneficiary of the taking is the private recipient of the condemned land. Also, as the *Kelo I* court noted, it is possible to harmonize some of the following cases with the holdings of cases such as *Berman*, *Midkiff*, and *Poletown*.[83]

One of the states that recently adopted a narrower view of the definition of "public use" was Michigan. In *County of Wayne v. Hathcock*, the Supreme Court of Michigan explicitly overruled *Poletown* and forbade the taking of the defendants' property to create a business and technology park near Metropolitan Airport.[84] The *Hathcock* court held that the term "public use" is a legal term of art that is a "positive limit on the state's power of eminent domain."[85] Also, the court stated it would not be as deferential to the legislature as it was under *Poletown*.[86] The court also held that there is a distinction between "public purpose" and "public use."[87] Under the *Hathcock* scheme, the former is not a limit on the eminent domain power; on the other hand, the latter is a substantial limit. Thus, the limitation gives the court a larger role in reviewing eminent domain cases. The court asserted its independence by holding that notwithstanding any legislative findings, it could determine if the legislature's asserted public use was constitutional.[88]

The *Hathcock* court also drew on Justice Ryan's *Poletown* dissent to hold that although Michigan's public use clause is "not an absolute bar against the transfer of condemned property to private entities," there are only three circumstances justifying the transfer of condemned property to a private party.[89] The first such situation is when the taking is required to satisfy a "public necessity of the extreme sort otherwise impracticable" unless the condemned land was transferred to a private entity.[90] To the court, this situation includes canals, railroads, highways and "other instrumentalities of commerce."[91] In these

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83. *See* Kelo v. City of New London (*Kelo I*), 843 A.2d 500, 535 (Conn. 2004), *aff'd*, 125 S. Ct. 2655, *reh'g denied*, 126 S. Ct. 24 (2005).

84. County of Wayne v. Hathcock, 684 N.W.2d 765, 770, 787 (Mich. 2004).

85. *Id.* at 780.

86. *See id.* at 785.

87. *Id.* at 784.

88. *Id.* at 785.

89. *Id.* at 781.

90. *Id.* (internal quotation marks omitted) (quoting Poletown Neighborhood Council v. City of Detroit, 304 N.W.2d 455, 676 (Mich. 1981) (Ryan, J., dissenting), *overruled by Hathcock*, 684 N.W.2d 765)).

91. *Id.* (internal quotation marks omitted) (quoting *Poletown Neighborhood Council*, 304 N.W.2d at 675 (Ryan, J., dissenting)).

situations, eminent domain is allowed because the construction of a private railroad could be halted by a single landowner who refused to sell an easement to his property for anything less than a price above market value.[92]

*Hathcock's* second justification for transferring condemned land to private entities is when the private grantee remains responsible to the public.[93] This situation allows for entities such as private utility companies to condemn land. The overriding concern is that the private entity will use the condemned property to benefit the public, and that the public controls the land "*independent of the will of the corporation taking it.*"[94] Finally, the court held that condemned land can be transferred to private entities "when the selection of the land to be condemned is itself based on public concern."[95] This situation covers cases such as slum clearance where a reviewing court looks at the reason that the condemning authority sought condemnation, instead of the land's post-condemnation use, to determine if the public use requirement is met.[96] In cases like slum clearance, the public use is the removal of unfit and unsanitary housing; the subsequent transfer to private parties is ancillary to the overriding use of removing the unfit housing.[97]

Based on this scheme, the court held that economic development to increase public revenues and employment does not justify the use of eminent domain.[98] The court held that these benefits are only incidental to the taking.[99] They are incidental because all lawful businesses contribute to the economy through employment and taxes.[100]

The Supreme Court of Illinois also recently proclaimed a narrower view of Illinois's public use clause in *Southwestern Illinois Development Authority v. National City Environmental L.L.C.*[101] The Southwestern Illinois Development Authority ("SWIDA") had instituted condemnation proceedings against National City Environmental ("NCE") so that NCE's land could be conveyed to a local racetrack. The racetrack wanted to use the land as its parking lot. NCE initially refused to sell its land to the racetrack. Eventually, the track convinced SWIDA to condemn the land.[102] SWIDA asserted the prevention and elimination of blight, promotion of public safety by alleviating traffic, and the economic redevelopment of the region as public uses.[103]

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92. *Id.* at 781-82.

93. *Id.* at 782.

94. *Id.* (internal quotation marks omitted) (quoting *Poletown Neighborhood Council*, 304 N.W.2d at 675 (Ryan, J., dissenting)).

95. *Id.* at 782-83.

96. *Id.* at 783.

97. *Id.*

98. *Id.* at 786-87.

99. *Id.* at 786.

100. *Id.*

101. 768 N.E.2d 1 (Ill. 2002).

102. *Id.* at 5-6.

103. *Id.* at 8.

The court began its analysis by noting that although the terms "public use" and "public purpose" are similar in meaning, the terms are distinguishable and not interchangeable.[104] The court also noted that although all three asserted public uses could be valid in certain cases, they were inapplicable to the instant case because the racetrack was a private entity and only a "mere benefit to the public [would] flow from the contemplated improvement."[105] By rejecting SWIDA's taking despite SWIDA's findings of public use, the court played a larger judicial role in public use cases. Thus, the court did not give the taking the same deferential review that jurisdictions following the *Poletown* and *Kelo I* models would have used. Also, the court indicated that it was willing to reverse a taking designed merely to assist private entities in "accomplishing their goals in a swift, economical, and profitable manner."[106] The court in *National City Environmental* inferred that SWIDA was interested in helping the racetrack accomplish its goals because SWIDA advertised that it would condemn land for private developers upon application and also from SWIDA's lack of an economic plan encompassing the racetrack.[107] Thus, the court showed that it would not uphold a taking designed to help a private entity reap profits, even if the taking resulted in an incidental public benefit.[108]

*National City Environmental* represents a substantial break from the analysis used in more deferential jurisdictions. However, as the *Kelo I* court noted, it is possible to harmonize the *National City Environmental* court's analysis with the analyses used in cases such as *Kelo I*, *Kelo II*, *Poletown*, and *Midkiff*.[109] The *Kelo I* court stated that *National City Environmental* perhaps represents "the far outer limit of the use of the eminent domain power for economic development."[110] However, although the *Kelo I* court thought that the nature of *National City Environmental*'s facts rationalized the court's analysis,[111] one could argue that the facts presented in *Kelo I* are just as, if not more, egregious than the facts presented in *National City Environmental*.[112] In *Kelo I*, many private homes were taken,[113] while in *National City Environmental*, the condemned land was used by commercial enterprises.[114]

Other jurisdictions have also given their public use requirements narrow

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104. *Id.*

105. *Id.* at 9 (quoting Gaylord v. Sanitary Dist. of Chicago, 68 N.E. 522 (1903)).

106. *Id.* at 10.

107. *Id.*

108. *Id.* at 9-10.

109. Kelo v. City of New London (*Kelo I*), 843 A.2d 500, 535 (Conn. 2004) (dictum), *aff'd*, 125 S. Ct. 2655, *reh'g denied*, 126 S. Ct. 24 (2005).

110. *Id.* (dictum).

111. *Id.* (dictum).

112. *See* discussion *supra* Part II.B.1.

113. *Kelo I*, 843 A.2d at 511.

114. *See* Sw. Ill. Dev. Auth v. Nat'l City Envtl., L.L.C., 769 N.E.2d 1, 4 (Ill. 2002); *see also* Nader & Hirsch, *supra* note 16, at 225 (noting that the taking of a home is different than taking property used for primarily economic purposes).

readings. For example, in *Georgia Department of Transportation v. Jasper County*,[115] the Supreme Court of South Carolina refused to allow property owned by the Georgia Department of Transportation to be condemned to make way for a stevedoring operation.[116] The court took one of the strongest possible positions regarding transfers to private entities. The court stated that it would not allow transfers of land to private entities "unless the property is taken for public use—a fixed, definite, and enforceable right of use, independent of the will of a private lessor of the condemned property."[117] The court took this approach because the eminent domain power is in "derogation of the right to acquire, possess, and defend property."[118]

## III. Problems Associated with Deferential and Broad Interpretations of "Public Use"

The broad, deferential standards announced in cases such as *Berman*, *Midkiff*, *Kelo*, and *Poletown* present four distinct problems. First, by giving a large amount of deference to the legislature, a broad reading of the Public Use Clause fails to protect individual private property rights. It also alters the takings incentive structure, making it much more likely that the government will exercise its eminent domain power. Additionally, the broad interpretations that allow condemned property to be transferred to private entities encourage private entities to engage in rent-seeking behavior. Finally, a broad interpretation fails to assure that the asserted public use is actually achieved.

### *A. Broad, Deferential Interpretations of "Public Use" Fail to Protect Private Property Rights*

Although the Federal Constitution was established to protect individual rights to life and liberty, it was also created to protect private property rights.[119] Courts adopting a broad interpretation of the public use requirement have failed to give effect to this fundamental purpose. This overarching purpose receives textual support from several provisions of the Constitution aside from the Takings Clause. For example, the Fourth Amendment guarantees that all persons shall "be secure in their . . . houses, papers, and effects, against unreasonable searches and seizures."[120] The Third Amendment also protects private property by placing great restrictions on the government's ability to quarter troops in private residences.[121] The Due Process Clauses of the Fifth and Fourteenth Amendments protect against deprivations of property "without due process of

115. 586 S.E.2d 853 (S.C. 2003).
116. *Id.* at 857.
117. *Id.*
118. *Id.* at 856.
119. Nader & Hirsch, *supra* note 16, at 208.
120. U.S. CONST. amend. IV.
121. *See* U.S. CONST. amend. III.

law."[122]

In addition to the aforementioned explicit protections of private property, the U.S. government was structured in part to protect individual private property rights. Indeed, the Framers believed that protecting private property rights was essential to protect personal liberty.[123] James Madison believed that, "Government is instituted to protect property of every sort; as well that which lies in the various rights of individuals . . . . This being the end of government, that alone is a just government, which impartially secures to every man, whatever is his own."[124] Additionally Madison believed that disparities in property ownership created the factions that government was instituted to control.[125] He believed that the Constitution was necessary to control "[a] rage for . . . an abolition of debts, for an equal division of property, or for any other improper or wicked project."[126] Thus, although courts have focused on the provisions of the Constitution guaranteeing individual liberties, the Framers were also intensely concerned with protecting private property rights.

Despite the Framers' intent to protect property rights, the broad, deferential interpretation of the Public Use Clause has failed to effectuate that intent. The U.S. Supreme Court has been quite unwilling to impose any standard that allows courts a meaningful role in determining what qualifies as a public use. The *Midkiff* Court did recognize that a successful taking requires a condemning authority to stipulate a public purpose; however, it provided that this requirement is satisfied when the condemnation is "rationally related to a conceivable public purpose."[127] A right is hardly protected when the only limit on the government's ability to derogate the right is that the act be within the broad bounds of rationality, i.e., the act must not be arbitrary.[128] Thus, without a meaningful check on the legislature, the legislature could conceivably accomplish the factional redistribution of wealth that the Framers feared.[129]

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122. U.S. CONST. amend. V (providing that "[n]o person shall . . . be deprived of life, liberty, or property, without due process of law"); U.S. CONST. amend. XIV, § 1 (prohibiting states from making deprivations "without due process of law").

123. *See* Ely, *supra* note 2, at 35.

124. Timothy J. Sandefur, *A Natural Rights Perspective on Eminent Domain in California: A Rationale for Meaningful Judicial Scrutiny of "Public Use,"* 32 SW. U. L. REV. 569, 580 n.58 (2003) (internal quotation marks omitted) (quoting JAMES MADISON, MADISON: WRITINGS 515 (J. Rakove ed., 1999)).

125. THE FEDERALIST No. 10, at 73-79 (James Madison) (Clinton Rossiter ed., 2003).

126. *Id.* at 79.

127. Haw. Hous. Auth. v. Midkiff, 467 U.S. 229, 241 (1984).

128. *See* discussion *supra* Part II.A.1.

129. Madison was concerned with mitigating the power of factions that would arise because of wealth inequalities. *See* THE FEDERALIST No. 10, *supra* note 125, at 73. Although he regarded the operation of a legislature as a way to maintain liberty, *see* THE FEDERALIST No. 49, at 313 (James Madison) (Clinton Rossiter ed., 2003), he believed that legislators were "advocates and parties to the causes which they determine," THE FEDERALIST No. 10, *supra* note 125, at 74. Using a bill regarding private debt as an example, Madison stated:

Thus, despite the conclusions reached in *Midkiff*, *Poletown*, and *Kelo II*, many courts seem to believe the Public Use Clause is a limitation on federal and state action. This conclusion is inconsistent with their analyses regarding what constitutes a public use for two reasons. First, even if the concept of public use is coterminous with police power,[130] the legislature can still abuse police power.[131] Thus, the limitation would not protect against the mischief the Framers feared. Second, if a citizen has the right not to have her land taken for anything but a public use, then the government has a corresponding duty to effectuate that right. However, the rational basis standard of review allows the government to fulfill its duty by stating a pretextual public purpose that may arise because of the taking, like increased tax and employment bases.[132] Thus, under these courts' analyses, a taking only would be unconstitutional if the legislature does not make an attempt to fit the taking into the current body of case law. Such a rule is problematic because it allows the general rule, that the government cannot take private property, to be swallowed by the exception, that private property may be taken for a public use. In a different context, the Supreme Court has stated that the Takings Clause requires more than this type of pretextual justification.[133]

The analysis employed by courts using the rational basis standard of review is also inconsistent with the standards these courts use to protect individual liberty. This inconsistency leads to the conclusion that courts have chosen not to use the clause to protect individual property rights. As Ralph Nader and Alan Hirsch note, although courts use heightened scrutiny to protect liberty and autonomy interests, the courts have not protected the property rights essential to meaningfully exercise these rights.[134] For example, the Supreme Court has consistently protected private and intimate activities inside the home, but has done little to protect the home itself.[135] However, although Nader and Hirsch

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> It is a question to which the creditors are parties on one side and the debtors on the other. Justice ought to hold the balance between them. Yet the parties are, and must be, themselves the judges; and the most numerous party, or in other words, the most powerful faction must be expected to prevail.

*Id.*

130. *Midkiff*, 467 U.S. at 240.

131. *See* Jeffrey W. Scott, *Public Use and Private Profit: When Should Heightened Scrutiny Be Applied to "Public-Private" Takings?*, 12 J. AFFORDABLE HOUSING & COMMUNITY DEV. L. 466, 473 (2003).

132. *See* Kelo v. City of New London (*Kelo I*), 843 A.2d 500, 520 (Conn. 2004), *aff'd*, 125 S. Ct. 2655, *reh'g denied*, 126 S. Ct. 24 (2005).

133. *See* Lucas v. S.C. Coastal Council, 505 U.S. 1003, 1025 n.12 (1992) (stating that simply requiring a recitation of a "harm-preventing" rationale is ineffectual for regulatory takings "[s]ince such a justification can be formulated in practically every case [and] amounts to a test of whether the legislature has a stupid staff"); *see also* Kelo v. City of New London (*Kelo II*), 125 S. Ct. 2655, 2675, *reh'g denied*, 126 S. Ct. 24 (2005) (O'Connor, J., dissenting).

134. *See* Nader & Hirsch, *supra* note 16, at 216.

135. *See id.*; *see also Kelo II*, 125 S. Ct. at 2685 (O'Connor, J., dissenting). Several Supreme Court cases have protected individual liberties as they relate to private conduct in one's home. *See,*

limit the type of property that makes the exercise of liberty interests meaningful to intimately personal property like one's home,[136] private property rights in general are necessary for individuals to be autonomous. Even investment and commercial property can enable personal autonomy. For example, the First Amendment's guarantees of freedom of speech and freedom of the press are nearly meaningless if individuals are not allowed to own the means necessary to communicate and publish information and opinions.

Ultimately, when courts such as the *Midkiff* and *Kelo II* courts analyze property rights cases differently from liberty rights cases, one could conclude that these courts do not view the Public Use requirement as a limitation on the government. For example, the Supreme Court has employed heightened scrutiny in many cases reviewed under the Fifth and Fourteenth Amendments where deprivations of liberty rights were at issue. This type of analysis provides that a government can abrogate liberty to a certain point, at which point it can go no further.[137] However, the Court has refused to recognize such a limitation with regard to property rights; the legislature's action must be only within the bounds of rationality.[138] However, the limitation of rationality is illusory[139] because the right to hold a particular piece of property is practically protected only to the extent that the condemning authority does not want to take it. Thus, the right practically exists only if the condemning authority chooses to recognize it. The Just Compensation Clause mitigates many effects of the taking by requiring that the property owner be reimbursed for his loss.[140] However, it may be impossible to completely compensate someone for the loss of his property.[141] Additionally, other burdens are usually visited upon the owner of condemned property, such as the necessity of looking for a new home and establishing ties to a new neighborhood.[142]

### *B. The Broad Interpretation of "Public Use" Alters the Takings Incentive Structure*

The broad interpretation of the Public Use Clause makes takings of private

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*e.g.*, Lawrence v. Texas, 539 U.S. 558 (2003) (protecting the right of adult homosexuals to engage in private, consensual intimate conduct); Griswold v. Connecticut, 381 U.S. 479 (1965) (protecting the right of married couples to use contraception).

136. *See* Nader & Hirsch, *supra* note 16, at 216.

137. Planned Parenthood of Se. Pa. v. Casey, 505 U.S. 833, 847 (1992) (stating that the Constitution promises "a realm of personal liberty which the government may not enter").

138. *See* Haw. Hous. Auth. v. Midkiff, 467 U.S. 229, 241 (1984).

139. *See supra* text accompanying notes 132-33.

140. *See* U.S. CONST. amend. V.

141. Nader & Hirsch, *supra* note 16, at 217 (noting that in *Poletown*, the owners of the condemned property did not lose merely income, but also the non-pecuniary attachment they had to their home and neighborhood).

142. *See generally* Garnett, *supra* note 46, at 951-61 (describing negative consequences of condemning land that can result even when compensation is made).

property much more likely because it virtually eliminates one of the limitations on the eminent domain power. This problem is exacerbated in situations where the condemned property will be transferred to a private party. In such a situation, the other limitation, the requirement of just compensation, is likely removed. The U.S. Constitution and most state constitutions have two provisions that deter the government from exercising its eminent domain power: the Public Use Clause and the Just Compensation Clause.[143] The Just Compensation Clause requires that the condemned property's owner be paid for the taking.[144] Thus, when a broad interpretation of the Public Use Clause is used, and the private party receiving the condemned land pays all of the expenses related to the condemnation, the government will not be easily deterred from using eminent domain because it will not have to expend its own resources.[145]

The theory behind the incentive structure of the Takings Clause is that even if a government can justify a legitimate public use, it will still be reluctant to abuse its power to take the property because it will have to pay just compensation and other expenses such as legal fees.[146] The lower the cost to the condemning authority, the more likely the condemning authority is to exercise the taking power, especially when a public purpose can be assumed. Indeed, in some cases, the condemning authority may actually have *incentive* to condemn private property for transfer to another private entity if the entity seeking the condemnation not only pays for the taking, but also pays a fee for the privilege.[147] This incentive structure is incompatible with the rational basis standard of review applied in Public Use cases. If the legislature is the sole institution charged with protecting people from improper uses of its eminent domain power,[148] it must surmount a tremendous conflict of interest before doing so. This conflict will be difficult to overcome, especially in cases where the land could be put to "more productive" uses and generate revenue that exceeds current tax revenue. Although some condemning authorities will resist the conflict of interest, others will not.[149] Thus, in many cases, the broad interpretation of the Public Use requirement is inconsistent with its justification for deference to the legislature.

In addition, many transfers of condemned property to private entities alter the takings incentive structure because they change the political equation the condemning authority must balance before declaring eminent domain. In a traditional exercise of the eminent domain power, such as condemning land to build a highway, the government has to weigh the political consequences of the

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143. *See* U.S. CONST. amend. V; *see also* Berliner, *supra* note 13, at 793.

144. *See* Berliner, *supra* note 13, at 793.

145. *See id.*

146. *See id.*

147. *See, e.g.*, Sw. Ill. Dev. Auth. v. Nat'l City Envtl., L.L.C., 768 N.E.2d 1, 4 (Ill. 2002) (stating that SWIDA required a fee of six to ten percent of the acquisition fee of the property to be paid for the service of condemning the property).

148. *See supra* text accompanying note 24.

149. *See, e.g., Nat'l City Envtl.*, 768 N.E.2d at 10 (noting that SWIDA advertised that it would condemn land for private entities for a fee).

taking. To finance the taking, the government will have to impose the costs of the taking on all of its citizens. When faced with either increased taxes or decreased services to finance the taking, taxpayers may be likely to bring political pressure to bear on the government's officials. Presumably, the officials will have to weigh the costs and benefits of expending their political capital before affecting the taking. However, when the government sells property to a private party that pays all the condemnation costs, the government officials do not have to expend as much political capital because they have placed almost all of the community's costs squarely on the owners of the condemned property and the private transferee.[150] In such a situation, the community as a whole will be less likely to oppose the taking because the vast majority of people will feel no negative effect from the taking. Thus, if the condemning authority selects the "right" individual or group on which to impose the costs of the taking, it will suffer little or no opposition. The "right" group may sometimes be a group of poor and politically powerless individuals,[151] but it could also be a commercial enterprise, which although fairly successful, is largely unsympathetic.[152]

### *C. A Broad, Deferential Interpretation of "Public Use" Encourages Rent-Seeking Behavior*

A rational basis standard for reviewing eminent domain actions encourages rent-seeking behavior because property value is generally greater post-condemnation.[153] The current eminent domain system gives this "surplus" value entirely to the post-condemnation owner.[154] This is done to promote the efficient use of resources and to discourage pre-condemnation owners from engaging in rent-seeking behavior themselves—that is, charging a greater price than their "opportunity cost."[155] This efficiency is generally necessary because the pre-condemnation owners' rent-seeking behavior can add substantial costs to the public project.[156] Thus, in a traditional takings case, the efficiency helps taxpayers because taxes will not be increased and services will not be decreased.

However, when condemned property is transferred to a private, profit-seeking entity, this rationale partly disappears. Of course, if the government

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150. Professor Garnett notes that one of the reasons that compensation for takings is required is because it prevents the government from "singling out" and "exploiting politically unorganized and vulnerable persons." Garnett, *supra* note 46, at 949 (internal quotation marks omitted) (citing Saul Levmore, *Takings, Torts, and Special Interests*, 77 VA. L. REV. 1333, 1344-45 (1991)).

151. *See* Nader & Hirsch, *supra* note 16, at 223.

152. *See, e.g.*, 99 Cents Only Stores v. Lancaster Redev. Agency, 237 F. Supp. 2d 1123, 1129 (C.D. Cal. 2001), *appeal dismissed as moot*, 60 Fed. Appx. 123 (9th Cir. 2003); *Nat'l City Envtl.*, 768 N.E.2d at 4.

153. *See* Thomas W. Merrill, *The Economics of Public Use*, 72 CORNELL L. REV. 61, 85 (1986).

154. *See id.* at 86.

155. *Id.* at 76, 86.

156. *See id.* at 85.

gratuitously transfers the property to a private entity, it is better economically to pay a lower price for the property. However, when a private owner pays the condemnation costs, it makes much less sense to give the private entity the surplus. In such a case, one hundred percent of the costs are imposed on a private entity that has actively sought out the condemned land. Thus, the taxpayers do not benefit from the financial savings that eminent domain provides.

In addition, the surplus created also encourages private parties to engage in rent-seeking behavior.[157] Eminent domain is attractive for private entities because they can obtain the land they want at prices below market value.[158] For this reason, private entities compete with each other in order to gain this economic surplus.[159] These competition costs can eliminate any surplus and lead to the inefficiency that eminent domain originally addressed.[160] Even if entities are not competing for the surplus, if the private entity has to make expenditures to defend the taking, then the surplus begins to disappear.[161]

Rent-seeking behavior by private entities is undesirable because it gives one entity a windfall at the expense of another. In a traditional eminent domain case, where the government will ultimately possess the land, the condemnee will at least receive the right to use a new or improved highway as a benefit. However, in cases where the condemned land is given or sold to a private entity, the pre-condemnation owner is involuntarily supplying land for a new use[162] and must surrender the surplus without being compensated for it. Thus, the new owner of the land receives a windfall that it did nothing to earn, and it owes no service or right of use to the pre-condemnation owner. This windfall is one of the key reasons that private entities keep seeking to use eminent domain. As long as governments are willing and able to provide for-profit entities with a windfall, the private parties will continue to seek it. The broad, deferential interpretation of "public use" promotes rent-seeking behavior because a profit-seeking entity can use almost any reason to justify its request to the condemning authority.

### *D. The Current Interpretation of "Public Use" Fails to Assure That the Asserted Use Is Achievable*

Frequently, when a government asserts economic redevelopment, increased taxes, or increased employment as a public use, it fails to require that the asserted use actually benefit the community.[163] Several jurisdictions have legislatively and contractually created "clawback" provisions that give the condemning authority the right to take back some or all of its investment costs if the

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157. *Id.* at 86.
158. *See* Garnett, *supra* note 46, at 958.
159. Merrill, *supra* note 153, at 86.
160. *Id.*
161. *See id.*
162. *Id.*
163. *See* Garnett, *supra* note 46, at 978.

contemplated benefit is not received.[164] Because these measures are legislative or contractual, the legislature is not obligated to make use of them in future takings. Thus, the provisions are not a substantial protection against legislative action. Under the rational basis standard, the state has no constitutional requirement to assure that the public benefit is actually achieved. In *Midkiff*, the Court stated, "[W]here the exercise of the eminent domain power is rationally related to a *conceivable* public purpose, the Court has never held a compensated taking to be proscribed by the Public Use Clause."[165] Thus, when analyzing a taking ex ante, as long as the asserted public use *could* happen, the taking is constitutional. There is no requirement that the public *actually* benefit from the taking.

When the condemning authority does not hold the private transferee of the condemned property accountable for not creating the asserted public use, the public suffers harm because it does not receive the anticipated use. Additionally, the pre-condemnation owner suffers a greater harm than he would have otherwise. In this case, the pre-condemnation owner not only suffers the loss of his property, he also does not share in the anticipated benefit.

In other cases, the taking's costs outweigh any possible benefit that could result from the taking. For example, in *Poletown*, Detroit paid $200 million for all of the condemned land. It sold the land to General Motors for eight million dollars.[166] In such a case, for a net economic benefit to accrue to the city and its residents, the benefits of economic redevelopment would have to exceeded at least $192 million. In addition, the social and political costs imposed by the taking, which in *Poletown* included displacement of the neighborhood's residents,[167] must be balanced against the social and political benefits that actually do result from the taking. Such a social or political benefit could include increased employment in the area. However, considering the combination of economic, political, and social costs and benefits, one is hard pressed to find that overall a net benefit actually accrued from the taking.

Under the broad interpretation of the Public Use Clause, the courts have little ability to determine if the public will actually benefit from the asserted use. The legislature is likely the only entity able to completely weigh the costs against the benefits. The legislature is not required to follow many of the procedural and evidence rules that courts use and it does not have to afford fact-finders any deference as courts exercising appellate review must. Indeed, the Supreme Court has found that determining what constitutes a public use can be "impracticable."[168] However, there are cases where the asserted benefits are

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164. *Id.* at 978-79.

165. Haw. Hous. Auth. v. Midkiff, 467 U.S. 229, 241 (1984) (emphasis added).

166. Jones, *supra* note 5, at 295.

167. *See* Garnett, *supra* note 46, at 953-55.

168. *See Midkiff*, 467 U.S. at 240-41 (quoting United States *ex rel.* Tenn. Valley Auth. v. Welch, 327 U.S. 546, 552 (1946)); *see also* Berman v. Parker, 348 U.S. 26, 32 (1954) (noting that in some cases the "purposes of government[] . . . [are] neither abstractly nor historically capable of complete definition").

hardly likely to match the costs imposed upon society and upon the former owners of the condemned land. Under the standard of review used in cases like *Midkiff* and *Kelo II*, the public use asserted by the legislature as a public use must merely be conceivable.[169] In such a case, the court will only be able to strike down takings where the costs could not possibly match the benefits of the taking, i.e., where there is no conceivable public purpose. The legislature generally has free reign to determine what is a legitimate government activity or public use. However, if it appears likely that the social, political, and economic costs of the taking will exceed its actual or asserted benefits, a presumption arises that the taking was really designed for private benefit and that the public use was only incidental.[170] The rational basis standard of review precludes courts from looking behind the asserted public use, even when the "red flag" of the costs obviously outweighing the benefits is waved.[171]

## IV. Recent Cases Offering a Narrower Interpretation of "Public Use" Do Not Adequately Protect Individual Property Rights

Although many recent cases have taken a narrower view of what constitutes a "public use" than *Berman*, *Midkiff*, and *Kelo II*, they have not gone far enough to protect private property rights. In many respects, these cases still allow a condemning authority to take a fairly broad view of what constitutes a "public use" when using eminent domain. The cases have not gone far enough to protect individual property rights because they do not establish a comprehensive standard that can be applied consistently by trial and appellate courts.

These cases undoubtedly use some form of heightened scrutiny and usually state a general test or definition of public use. However, in many cases, the court's analysis provides little guidance for courts facing different sets of facts. Even in *Georgia Department of Transportation v. Jasper County*, which offers the narrowest definition of "public use,"[172] the court's analysis is thin. Although the case stated that "a fixed, definite, and enforceable right of use, independent of the will of a private lessor of the condemned property" is necessary to meet South Carolina's public use clause, it provided little analysis as to what factors courts should look to in determining whether the taking contemplated "a fixed,

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169. *See Midkiff*, 467 U.S. at 241; Kelo v. City of New London (*Kelo I*), 843 A.2d 500, 528 (Conn. 2004) (stating that analyzing takings under the federal and Connecticut public use provisions requires a "deferential and purposive approach"), *aff'd*, 125 S. Ct. 2655, *reh'g denied*, 126 S. Ct. 24 (2005).

170. Many courts have held that if the taking is primarily to benefit a private party, the taking is unconstitutional. *See, e.g.*, Gen. Bldg. Contractors, L.L.C. v. Bd. of Shawnee County Comm'rs, 66 P.3d 873, 883 (Kan. 2003).

171. *See Midkiff*, 467 U.S. at 243 (stating that federal courts are not to engage in "empirical debates over the wisdom of takings—no less than debates over the wisdom of other kinds of socioeconomic legislation").

172. *See* Ga. Dep't of Transp. v. Jasper County, 586 S.E.2d 853, 857 (S.C. 2003).

definite, and enforceable right of use."[173] However, this statement is not as comprehensive as it seems. Without elaboration, the standard leaves open the question whether a private entity such as a utility or a railroad could use eminent domain to accomplish its goals.[174] Thus, although the general standard reads well, it creates many practical difficulties that a comprehensive standard would remedy.

*Hathcock* follows the pattern of *Georgia Department of Transportation*. Although the *Hathcock* court set out three circumstances that could justify condemning property and transferring it to a private entity,[175] the court did not set a comprehensive standard that would prevent a condemning authority from abusing its eminent domain power. For example, one circumstance justifying transferring condemned land to a private party is slum clearance.[176] In such a case, the public use is the very selection of the land to be condemned and not its post-condemnation use. This circumstance is problematic as it allows a condemning authority to assert a "public concern"[177] that is similar to slum clearance and then justify the taking by noting the importance of the taking relative to its police powers and the putative public concern. For example, a condemning authority could assert that the taking is necessary to effectuate city or county planning purposes. Such a justification could supplant the justifications of increased taxes, increased employment, and economic redevelopment as the fallback "public use" to be asserted when no other justification seems to fit. Indeed, the principal problem is that if the taking itself and not its subsequent use can be justified by an exercise of a power derivative of the condemning authority's police power, then this limitation is virtually indistinguishable from *Midkiff*'s holding that the public use requirement is "coterminous with the scope of a sovereign's police powers."[178]

In other cases, the courts examine the facts without reference to any clearly annunciated standard of review when determining if the asserted use is constitutional. For example, in *National City Environmental*, the court stated that "[t]he public must be to some extent entitled to use or enjoy the property, not as a mere favor or by permission of the owner, but by right."[179] However, the court did little to analyze the case in light of this standard. The court merely made the conclusory statement that the "condemnation clearly was intended to assist [the racetrack] in accomplishing their goals in a swift, economical, and

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173. *See id.* at 856-57.

174. *See id.* at 856 (stating that the phrase "public use implies possession, occupation, and enjoyment of the land by the public at large or by public agencies" (citing Edens v. City of Columbia, 91 S.E.2d 280, 283 (S.C. 1956))).

175. *See* County of Wayne v. Hathcock, 684 N.W.2d 765, 781-83 (Mich. 2004); *see also supra* notes 89-97 and accompanying text.

176. *See Hathcock*, 684 N.W.2d at 782-83.

177. *Id.* at 783.

178. *See* Haw. Hous. Auth. v. Midkiff, 467 U.S. 229, 240 (1984).

179. Sw. Ill. Dev. Auth. v. Nat'l City Envtl., L.L.C., 768 N.E.2d 1, 9 (Ill. 2002) (alteration in original) (internal quotation marks omitted).

profitable manner."[180] It also noted that SWIDA was acting in an overtly *ultra vires* manner.[181] This analysis is unfortunate because although it reaches a desirable result, it does little to help future courts decide takings cases. Because the analysis centered in large part around the facts presented, the decisions are easily distinguishable in future cases.[182]

## V. A PROPOSED HEIGHTENED SCRUTINY TEST FOR ANALYZING PROBLEMATIC EMINENT DOMAIN CASES

The overarching purpose of any test that analyzes takings should be to protect private property from being condemned to advance the ends of other private entities. To this end, with the exception of a narrow range of cases, any proposed taking where the land will subsequently be transferred to a private entity should be automatically suspect and subjected to heightened scrutiny. The purpose of the standard of review delineated below is to set forth the type of heightened scrutiny that should be used in such a case. In addition, the main purpose of this standard of review is to prevent condemning authorities from using increased revenue, increased employment, or economic redevelopment as a mere pretext to meet the Public Use Clause. This is not to say that it is impermissible to take account of these asserted uses or benefits when assessing a taking's constitutionality. In addition, the proposed standard of review recognizes that a bright-line test is simply impracticable because it is impossible to determine all problematic takings. As times change, new problematic takings will arise. This impracticability occurs whether the bright-line test is phrased as "condemned land may be transferred to a private entity in any case with the following exceptions" or "condemned land may never be transferred to a private entity except in the following circumstances."

Before using the test, a threshold question must be answered. The court must first determine whether the possessory interest in the land, be it freehold or leasehold, will inhere in the sovereign or its agencies, a political subdivision or its agencies, a railroad, or a state-regulated public utility company, such as electric, gas, or water companies.[183] If one of these entities will hold the ultimate possessory interest in the land, then the court should analyze the case according to traditional principles of eminent domain jurisprudence. These cases should be analyzed under traditional principles because the public uses in these cases have generally been uncontroversial.[184] If the taking does not meet one of the

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180. *Id.* at 10.

181. *See id.*

182. *See supra* notes 109-11 and accompanying text.

183. *See* Scott, *supra* note 131, at 475 (noting that, as a factor of his proposed test, the property must be owned or leased by a private entity, because that is the "essential element of a public-private taking").

184. *See* Berliner, *supra* note 13, at 791; *see also* Scott, *supra* note 131, at 466 (noting that, in the past, condemned land transferred to private individuals has led to benefits such as electrical lines and railroads).

conditions set forth in the threshold question, the court should proceed with the following test. In these cases, the property's taking and subsequent transfer to a private entity raise an issue that is neither routine nor well-settled.

### *A. Three-Prong Analysis for Using Heightened Scrutiny*

If a taking does not satisfy the threshold question posed above, then the condemning authority must defend the taking by passing the following three-pronged test by clear and convincing evidence.[185] The first prong requires the condemning authority to show that transferring the land to a private entity is the only practicable way of accomplishing a legitimate objective. The second prong requires the condemning authority to demonstrate before taking the property that the asserted public use will accrue to the public in a reasonable period of time. Finally, the condemning authority must also prove that the private transferee of the land will not receive the benefit of the surplus value that condemning the land creates.

*1. Prong One: Only Practicable Method of Accomplishing a Legitimate Objective.*—The first prong requires the condemning authority to show that transferring the condemned property from one private entity to another is the only practicable method of accomplishing a legitimate objective.[186] This prong is worded similarly to the first circumstance stated in *Hathcock* that justifies transferring condemned property to a private entity.[187] However, this prong is not intended just to cover cases involving "highways, railroads . . . and other instrumentalities of commerce,"[188] but rather may be used in all cases that involve a legitimate objective. A legitimate objective is a goal that the

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185. This burden of proof and level of persuasion requirement is a loose adaptation of Professor Ely's proposals regarding the type of takings at issue in this Note. *See* Ely, *supra* note 2, at 36. Specifically, Professor Ely believed that people should not have their property rights coercively abrogated "without a compelling justification" and that the "courts should place the burden on the condemnor to make a convincing case for the acquisition." *Id.*; *see also* Kelo v. City of New London (*Kelo I*), 843 A.2d 500, 587-88 (Conn. 2004) (Carella, J., dissenting), *aff'd*, 125 S. Ct. 2655, *reh'g denied*, 126 S. Ct. 24 (2005).

186. Thomas Posey argues that a feasibility test should be used when "the government is highly unlikely to use the condemned land to complete the necessity project." Posey, *supra* note 61, at 1417. His "highly unlikely" standard differs from this prong because it is a threshold question that determines how the burden of persuasion is allocated. *See id.* Additionally, under his test the government needs only a rational basis to meet its burden of proof. *Id.* at 1418. Rational basis review is inconsistent with the underlying rationale of the test proposed in this Note.

187. *See* County of Wayne v. Hathcock, 684 N.W.2d 765, 781 (Mich. 2004) (dictum) (stating that condemned land may be transferred to a private entity when the case "involve[s] 'public necessity of the extreme sort otherwise impracticable'" (quoting Poletown Neighborhood Council v. City of Detroit, 304 N.W.2d 455, 675 (Mich. 1981) (Ryan, J., dissenting), *overruled by* County of Wayne v. Hathcock, 684 N.W.2d 765 (Mich. 2004))).

188. *See Hathcock*, 684 N.W.2d at 781 (internal quotation marks omitted) (quoting *Poletown Neighborhood Council*, 304 N.W.2d at 675 (Ryan, J., dissenting)).

condemning authority has the power to bring about, notwithstanding any takings issues. For example, in the case of Congress, the prong only allows a taking when it exercises one of its enumerated powers.

The prong requires a state's action to be within the bounds of its police powers and its constitution. In addition, when something is the only practicable method of accomplishing a goal, it is the only feasible method of accomplishing the goal.[189] This does not necessarily mean that the taking is the only *possible* method that could accomplish the goal, but that it is the only method that could *reasonably be considered* when accomplishing its goal. Thus, it is similar to the concept of narrow-tailoring that is used to analyze cases under the Due Process and Equal Protection Clauses of the Fourteenth Amendment.[190]

This prong of the test offers several advantages. First, it partially follows *Berman*, *Midkiff*, and *Kelo II* by allowing the legislature, and not the courts, to generally determine what is a legitimate use of its powers.[191] This assuages the courts' fears that they will be meddling in the affairs traditionally allocated to the legislative branch. A related advantage is that in many cases, the courts can easily review whether the asserted purpose or use of the contemplated taking is even within the condemning authority's power. For example, in a case such as *National City Environmental*, where the condemning authority was not a sovereign or one of its political subdivisions, but rather a municipal corporation with limited purpose,[192] the court can very easily test if an entity such as this is acting *ultra vires*.

This prong also has several advantages with regard to protecting individual property rights. First, it drastically limits the number of circumstances that allow a condemning authority to transfer one person's land to another private party because the post-condemnation transfer will only occur in cases where it would be nearly impossible to accomplish the legislative objective otherwise. Second, the prong provides more protection than the traditional rational basis standard. This prong guarantees that the courts will thoroughly examine the rationale underlying the taking before granting its approval. Thus, it lessens the judicial deference to the legislature because the condemning authority will have to justify the taking and show how condemning the property and then transferring it to another private entity will fulfill that justification. It must also show that virtually no other means can accomplish the goal. The condemning authority will not be able to merely state as a pretext that increased taxes, increased employment, or economic redevelopment may arise from transferring the

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189. BLACK'S LAW DICTIONARY 1210 (8th ed. 2004).

190. For a discussion of narrow-tailoring, see generally *Grutter v. Bollinger*, 539 U.S. 306 (2003) (discussing narrow-tailoring with regard to affirmative action). In addition, although this prong is similar to the narrow-tailoring portion of strict scrutiny analysis, it does not require a compelling state interest.

191. *See* Berman v. Parker, 348 U.S. 26, 32 (1954) (stating that "[t]he definition [of the police power] is essentially the product of legislative determinations addressed to the purposes of government, purposes neither abstractly nor historically capable of complete definition").

192. *See* Sw. Ill. Dev. Auth. v. Nat'l City Envtl., L.L.C., 768 N.E.2d 1, 3 (Ill. 2002).

property to a private entity. This prong changes the question from "Can a legitimate legislative end rationally result from the taking?" to "Is the taking the only reasonable way that the legislature can accomplish its goal?" The questions are distinct and the latter greatly mitigates undue judicial deference that the former allows.[193]

This prong also provides for strong protection of property rights. The prong rebalances the takings equation by emphasizing the individual's right to own the private property and by deemphasizing the condemning authority's power to take private property. This reemphasis on private property rights attempts to bring eminent domain jurisprudence in line with the other provisions of the Constitution that protect private property and the Framers' view that the Constitution was designed to protect private property rights.[194]

In addition to increasing the protection of private property rights, the first prong also enables courts to substantively treat derogations of property rights similarly to derogations of "fundamental" liberty interests.[195] This prong may provide for different protection for private property rights than substantive due process analysis provides for "fundamental" liberty interests. However, the prong sets discernable boundaries that represent the extent of the state's ability to derogate private property rights.[196]

The high standard that the proposed test's first prong sets will undoubtedly have many detractors. Many legislators, governors, mayors, and officials heading entities with eminent domain power believe that they need the ability to take land cheaply and easily to accomplish their state or city's redevelopment and economic goals.[197] Some courts and judges undoubtedly find this view persuasive. For example, Justice Freeman expressed concern in his *National City Environmental* dissent that the Supreme Court of Illinois's enhanced standard of review would be the death knell of "legislation in furtherance of economic development and revitalization."[198] Indeed, many states and cities believe that economic redevelopment is necessary to increase tax revenues that are needed to pay for government services.[199] These critics could claim that this prong would eliminate a state or city's ability to redevelop and revitalize because any other practicable option must be unavailable or exhausted before eminent domain can be used to affect the legislative goal.

The potential fears of these critics would be misplaced. Underlying this

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193. *See* discussion *supra* Parts II.A.1, II.B.1, III.

194. *See* discussion *supra* Part III.A.

195. *See* discussion *supra* Part III.A.

196. *See supra* text accompanying note 137.

197. *See* Matthew Tully, *House OKs Higher Price for Eminent Domain*, INDIANAPOLIS STAR, Feb. 22, 2005, at B4.

198. Sw. Ill. Dev. Auth. v. Nat'l City Envtl., L.L.C., 768 N.E.2d 1, 26 (Ill. 2002) (Freeman, J., dissenting).

199. *See, e.g.*, *id.* at 20-21 (noting that unemployment has increased state needs to pay for public assistance programs and that if the unemployed residents leave to find employment, tax revenues will be reduced to pay for these obligations).

prong is the assumption that in most cases there will be another feasible way to accomplish the legislative goal. Thus, economic redevelopment can still be accomplished. This prong simply forces a condemning authority to change some of the methods by which it accomplishes its goals. For example, if a city wanted to revitalize, it could alter its plans, focusing on takings requiring a lesser standard of review, enticing the current owners of the land to move through increased payouts or tax incentives. The condemning authority would be required to exhaust *reasonable* alternatives before exercising its eminent domain powers.

In addition, instead of foreclosing the possibility of economic redevelopment, the prong assures that economic redevelopment is the true issue and not merely pretextual. The more a condemning authority insists on condemning a certain parcel of land that a private entity desires, the more reasonable is the inference that a taking is only "to achieve the naked transfer of property from one private party to another."[200] Such an inference militates against calling a taking a "public use."

*2. Prong 2: Assuring that the Asserted Public Use Will Accrue in a Reasonable Time.*—The second prong of the three prong test requires a reviewing court to determine if an asserted public use has a reasonable chance of accruing in a reasonable amount of time.[201] For example, if a state or city wishes to condemn property for the construction of a shopping mall, it will have to justify how the construction is a public use and what the use's benefits are. Once the court determines the end being pursued by the legislature, this prong is used to determine if the taking and the subsequent transfer to a private entity can actually fulfill the asserted public use in a reasonable period of time. Thus, if the aforementioned shopping mall's purpose is to stimulate other economic growth in the area, that reviewing court must determine that the shopping mall's construction could reasonably accomplish that goal.

This prong remedies cases where land is condemned and transferred to a private entity and the benefit to be derived from the asserted use does not accrue to the public at all or at least within a reasonable time.[202] Additionally, this prong is designed to deter a condemning authority from asserting a pretextual public use. Pretextual assertions will be decreased because if the condemning authority is able to produce only minimal evidence that a benefit could accrue, it will be easier for the trier of fact to conclude that the taking was actually designed to benefit a private party when analyzing this prong.

To give complete effect to this prong, a reviewing court should require the

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200. 99 Cents Only Stores v. Lancaster Redev. Agency, 237 F. Supp. 2d 1123, 1129 (C.D. Cal. 2001) (explaining that the only reason that eminent domain was declared was to satisfy Costco's expansion demands), *appeal dismissed as moot*, 60 Fed. Appx. 123 (9th Cir. 2003).

201. Brief for Petitioner at 36, Kelo v. City of New London (*Kelo II*), 125 S. Ct. 2655 (No. 04-108), *reh'g denied*, 126 S. Ct. 24 (2005) (arguing that use of eminent domain to achieve "economic redevelopment" should only be authorized if "there is reasonable certainty" that public benefits will accrue).

202. *See* discussion *supra* Part III.D.

condemning authority to present statistics and other relevant data to support its assertions. This is a noted departure from the rational basis test offered by *Berman* and *Midkiff*. This prong requires a court to look at the taking ex ante to determine if the asserted benefits are likely to occur. This is in stark contrast to the *Midkiff* approach which only requires that the condemning authority "rationally *could have* believed that the [Act] would promote its objective."[203] By requiring the condemning authority to provide evidence that the benefit from the use is likely to accrue, this prong substantially limits the deference given to legislative findings and their determinations regarding what constitutes a public use.

Furthermore, because the court will require evidence that the public use will result from the taking, the public at-large will also have access to detailed information regarding the proposed taking and subsequent transfer to a private entity. This also enables increased media scrutiny of the taking, which is especially valuable if the taking is controversial. Additional access to information will allow the pre-condemnation owners of the land and other members of the public to seek not only legal, but political redress against the government. Because political redress will be more effectively sought, the takings incentive structure will be altered so that it is more in line with the incentive structure for a traditional taking, such as a highway.[204] The information allows the incentive structure to be altered because the media and other interested parties will have access to the information necessary to engage the public at-large. The incentive structure will also be changed because the interested parties have the burden of proving that the asserted benefit will likely not accrue or that the taking is a poor policy choice. Inertia or lack of resources will likely prevent the interested parties from proving these matters. If interested parties do not have access to the requisite information, they will never persuade the public at-large.

This prong can also be fulfilled through the use of contractual or legislative "clawback" provisions that take title back from the private transferee if the new owner fails to effectuate the asserted public use.[205] Although these provisions alone will not fulfill prong two in most cases, they can provide evidence that a measurable benefit will accrue to the public. It is reasonable to assume that if a private entity will be penalized for not bringing about a certain result, then that private entity will likely put forth effort to achieve the result. Additional incentives and disincentives may be used to supplement proof of the likelihood that the benefit will be achieved.

This prong could result in a condemning authority being reluctant to condemn property if there is a risk that a benefit will not occur. Thus, this prong could result in opportunities that could provide a high return on the social, economic, and political capital being lost because the condemning authority

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203. Haw. Hous. Auth. v. Midkiff, 467 U.S. 229, 242 (1984) (emphasis added) (alteration in original) (internal quotations omitted) (quoting W. & S. Life Ins. Co. v. State Bd. of Equalization, 451 U.S. 648, 671-72 (1981)).

204. *See* discussion *supra* Part III.B.

205. *See supra* notes 163-64 and accompanying text.

refuses to take the risk. Although it is true that a condemning authority might not take advantage of some potentially high-yield transactions, the prong does not require the condemning authority to absolutely convince the court that the asserted benefit will definitely occur or is extremely likely to occur; such a level of proof would be difficult or impossible to meet. A condemning authority would only need to prove that it is *likely* that the asserted benefit will occur. The purpose of this prong is to prevent the condemning authority from declaring eminent domain based on a public purpose that is merely speculative and from asserting the public use only when litigation ensues from a challenged taking.

In addition, although some high-yield transactions will be foregone, one must remember that many high-yield transactions will be high-yield not because the benefits to the condemning authority will be exceedingly high, but rather because the costs to the city will be exceedingly low.[206] In many cases, the cost is so low because the condemning authority has singled out the condemned property owner and because the authority has passed on the economic costs to the private transferee.[207] Thus, in such a case, many of the high-yield transactions do not require the condemning authority to subject itself to much risk.

*3. Prong 3: Private Transferee Does Not Receive the Surplus Created by the Taking.*—The final prong of the proposed test requires the government to show that the private transferee of the land will not receive gratuitously the surplus value that represents the difference between the pre-condemnation and post-condemnation values. This prong is needed to prevent much of the rent-seeking behavior engaged in by many private entities.[208] To achieve this purpose, it is necessary for the private transferee of the land to pay the post-condemnation market value of the land. This is not to say that the pre-condemnation owner of the land will receive this total amount as part of his compensation for the land.[209] Rather, the post-condemnation transferee will be required to pay the fair market value for the land and pay to make the necessary improvements to the land.

Successful implementation of this prong will help repair the incentive structure that has been harmed by the current abuse of the Public Use Clause. By subjecting the private transferees to market pressures, they will be less likely to seek eminent domain as a means to accomplish their ends. Eminent domain is currently attractive to corporations because they could get the land that they want at substantial savings;[210] thus, it follows that these corporations will be much less likely to seek eminent domain to take the land if they face increased economic and political costs. Thus, if private parties are less willing to seek out eminent domain as a means to achieve their ends, the government will be less likely to use it as well, even if the costs imposed on it remain low.

In addition, the takings incentive structure is repaired because it reduces the

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206. *See supra* notes 146-47 and accompanying text.

207. *See supra* note 150 and accompanying text.

208. *See* discussion *supra* Part III.C.

209. It should be noted that this prong of the test is not designed to alter the analysis of what constitutes just compensation. *See* U.S. CONST. amend. V.

210. *See* Berliner, *supra* note 13, at 793.

likelihood that property owners will be singled out.[211] The pre-condemnation owners of land will be less likely to be singled out because the condemning authority will be less likely to use eminent domain. In addition, because private entities will seek eminent domain less often, the government will attempt to use other incentives to accomplish its redevelopment objectives. For example, a state or local government could use property tax abatements to further its goals. However, to some extent eminent domain will always result in some singling out because only a finite group of people will have their land taken in any given case. This prong is designed, in part, to mitigate the singling out.

Unfortunately, it is nearly impossible to design an incentive scheme that simultaneously decreases the desire of the government and of a private entity to use eminent domain. This is because increased cost to one increases the desire of the other to use eminent domain. However, it is likely best for the test to subject private entities to greater economic costs because those costs are more likely to deter them from seeking eminent domain. As Professor Garnett notes, "compensation alone may underdeter the government from exercising the power of eminent domain."[212] Professor Garnett states that this is true "[b]ecause government actors respond to political, not market, incentives."[213] As a matter of policy, it is better to place the financial costs on the party that will be most deterred by their imposition.

This prong still makes it possible for governments to accomplish their redevelopment goals despite the imposition of greater costs on the private transferee. First, fair market value for the property may still be a good deal. A private developer can realize gains even by paying fair market value. In addition, because the market value of the property should be measured in light of the new use, the private transferee could realize gain if the development does better than expected or if new businesses and development are attracted to the area as a result of the redevelopment.

In addition, this prong does not foreclose the possible use of other incentives. Incentives such as tax increment financing or offering to buy a certain quantity of the business's products can be used to entice businesses to come into an area and redevelop it.[214] Many of these incentives could still be used in conjunction with eminent domain or by themselves.

### *B. Defending the Test*

The test as a whole will undoubtedly be criticized. It will likely face two

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211. *See supra* note 150 and accompanying text.

212. Garnett, *supra* note 46, at 956.

213. *Id.* (alteration in original) (internal quotation marks omitted) (quoting Daryl J. Levinson, *Making Government Pay: Markets, Politics, and the Allocation of Constitutional Costs*, 67 U. CHI. L. REV. 345, 347 (2000)).

214. Professor Garnett provides a partial list of additional incentives that have been used to entice corporations to relocate and includes some extreme examples. *Id.* at 958. She also notes that there is evidence that these incentives do not accomplish their purpose because of competition. *Id.*

principle criticisms. Some will argue that strict scrutiny or another form of heightened review should be used to analyze these types of cases. Others will contend that the test does not go far enough in protecting private property rights because property rights are not given the same protection as liberty rights.

Many commentators who have analyzed the problem posed by the broad, deferential standard of review offered by cases such as *Berman* and *Kelo II* have argued that the strict scrutiny used to analyze violations of Due Process and Equal Protection rights should be used to analyze eminent domain cases.[215] Others have argued that heightened scrutiny should be applied when certain elements or factors are present.[216] Although strict scrutiny or a general form of heightened scrutiny would be successful in limiting the occurrence of problematic takings,[217] these methods of review do not specifically address the problems occasioned when private transferees receive condemned property. Thus, the proposed test attempts to eliminate the problems caused by problematic takings rather than simply looking for problematic takings and applying a one-size-fits-all test. Additionally, the test proposed provides a predetermined framework so condemning authorities can analyze their actions ex ante. In contrast, under strict scrutiny and some heightened standards, absent prior precedent, the condemning authority will never be certain whether or not a court will deem a taking's justification "compelling."[218]

Some critics could argue that this test does not go far enough in preventing abuses of property rights because the protection it provides is not the same protection afforded to liberty rights. It is true that the above test does not provide protection identical to that of liberty rights. However, property rights are different than liberty rights, and therefore merit different, although equal, kinds of protection. Different problems arise with property rights as opposed to liberty rights. The test and its implications provide a high level of protection for cases where one private party will be forced to sell his land to another private entity. This is principally accomplished by the requirement that there be no other practicable method of achieving the legislative interest. The requirement erects a substantial barrier to transferring condemned property to private entities after the taking occurs.

In addition, property rights merit a different type of protection than liberty rights because of the ability of the government to take property for public use. The United States has a long history of taking private land to be given to another private individual.[219] The justifications for some of these takings have been long

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215. *See, e.g.*, Nader & Hirsch, *supra* note 16, at 224.

216. *See, e.g.*, Scott, *supra* note 131, at 474-79.

217. *See* Adarand Constructors, Inc. v. Pena, 515 U.S. 200, 237 (1995) (stating that strict scrutiny has been accused of being "strict in theory, but fatal in fact" (quoting Fullilove v. Klutznick, 448 U.S. 448, 519 (1980) (Marshall, J., concurring in judgment))).

218. *See id.* (noting that the strict scrutiny test is satisfied when action is "necessary to further a compelling interest" and satisfies "the 'narrow tailoring' test").

219. Scott, *supra* note 131, at 468.

established.[220] As time moves forward and technology changes, it is important to have a standard, that while vigorously protecting private property rights, also permits the establishment of new public uses that allow the government to accomplish its tasks more effectively.

## CONCLUSION

There is substantial disagreement among jurisdictions regarding where the line between public use and private use is drawn and which branch of government is the appropriate one to draw it. Thus, it truly matters which jurisdiction's law controls when determining if a post-condemnation transfer of land to a private developer is constitutional. Many jurisdictions have taken the view that the legislature gets to determine what the public use is and can use eminent domain in any rational way to affect that goal. Other jurisdictions have used a variety of approaches that take a much narrower view of what the Public Use Clause demands.

The jurisdictions that have adopted a broad interpretation of "public use" have done so in error. The deferential interpretation primarily fails to give effect to the Framers' intent that individual private property rights should be protected. These jurisdictions fail to give effect to the Framers' intent by not treating property rights as equivalent to liberty rights. The broad interpretation of the Public Use Clause is bad public policy because it makes the government more likely to take private property because the interpretation alters the takings incentive structure and encourages private entities to engage in rent-seeking behavior. Also, it is bad public policy to allow a private person's land to be taken and transferred to another private entity when the government has not shown that any benefit is likely to accrue.

Additionally, jurisdictions that utilize a narrower interpretation of "public use" and apply some level of heightened scrutiny have not gone far enough in protecting private property rights. Although the cases discussed above may represent the beginning of a movement to use heightened scrutiny in public use cases, such a movement has not fully materialized. Many of these cases contain language that future courts could abuse in future takings cases or do not provide clear standards for reviewing courts to utilize. Also, in some cases, it is possible to harmonize the courts' holding with cases like *Berman* and *Midkiff*, which allowed for a broad interpretation of "public use."

Courts should go farther and adopt a comprehensive test that provides for heightened scrutiny of takings when the condemned property is to be subsequently transferred to a private entity. Such a test should remedy the problems that the broad, deferential standard of review has created. At the same time, the standard should be flexible enough to allow for changes in society and technology that the legislature will have to meet. However, the standard should in every case assure that property rights are held on an equal, although not identical, plane as liberty rights.

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220. *See id.* at 475.

This Note has proposed a change in the jurisprudence interpreting existing provisions. To the extent that a jurisdiction finds its courts unwilling to affect a doctrinal shift, legislative or constitutional changes may be required to bring about change.[221] Such a change will undoubtedly require active engagement of the legislature and, in many cases, the public. Such changes may be difficult to accomplish, but, if faced with a court that will not change its jurisprudential position, it may the be the only option available if a person's right to own private property is to be adequately protected.

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221. As of this writing, a bill is pending in Congress that would deny federal funding to projects that utilize eminent domain for economic development. H.R. 3135, 109th Cong. § 2 (2005). The bill also forbids the U.S. government from using economic development as a justification for its exercise of eminent domain. *Id.*